

**EXHIBIT B to the Declaration Of Laura W. Sawyer In Further
Support Of Debtors' Motion For An Order Excluding The
Testimony Of Daniel Curry And Jeffrey Hasterok**

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In Re: LEHMAN BROTHERS) Chapter 11 Case
) No. 08-13555
HOLDINGS, INC., et al.,) (JMP)
) (Jointly
Debtors.) Administered)
_____)

DEPOSITION OF DAVID F. BABEL

New York, New York

Friday, March 7, 2014

Reported by:
PATRICIA A. BIDONDE, RPR

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<p>1 2 3 4 5 6 March 7, 2014 7 10:04 a.m. 8 9 10 Deposition of DAVID F. BABBEL, 11 held at the offices of JONES DAY, 12 222 East 41st Street, New York, New York, 13 before Patricia A. Bidonde, a Registered 14 Professional Reporter and Notary Public 15 of the State of New York. 16 17 18 19 20 21 22 23 24 25</p>	<p>1 2 IT IS HEREBY STIPULATED AND 3 AGREED, by and between the attorneys for 4 the respective parties herein, that 5 filing and sealing be and the same are 6 hereby waived. 7 IT IS FURTHER STIPULATED AND 8 AGREED that all objections, except as to 9 the form of the question, shall be 10 reserved to the time of the trial. 11 IT IS FURTHER STIPULATED AND 12 AGREED that the within deposition may be 13 sworn to and signed before any officer 14 authorized to administer an oath, with 15 the same force and effect as if signed 16 and sworn to before the Court. 17 18 19 20 21 22 23 24 25</p>
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<p>1 2 APPEARANCES: 3 4 JONES DAY 5 Attorneys for Debtors 6 222 East 41st Street 7 New York, New York 10017-6702 8 BY: JAYANT W. TAMBE, ESQ., 9 JENNIFER DEL MEDICO, ESQ., 10 LAURI SAWYER, ESQ. 11 12 PACIFICA LAW GROUP 13 Attorneys for Washington State Tobacco 14 Settlement Authority 15 1191 2nd Avenue 16 Suite 2100 17 Seattle, Washington 98101 18 BY: PAUL J. LAWRENCE, ESQ. 19 20 21 ALSO PRESENT: 22 DEAN MELCHIOR 23 24 25</p>	<p>1 D. Babel 2 PROCEEDINGS 3 DAVID F. BABBEL, 4 called as a witness, having been duly 5 sworn by a Notary Public, was examined 6 and testified as follows: 7 EXAMINATION BY 8 MR. LAWRENCE: 9 Q. Please state your full name for 10 the record and spell your last name, please. 11 A. David Frederick Babel, 12 B-a-b-b-e-l. 13 Q. What is your business address? 14 A. 215 Wakefield Road, Bryn Mawr, 15 Pennsylvania. 16 Q. We were introduced before the 17 deposition. My name is Paul Lawrence, and I 18 represent the Washington State Tobacco 19 Settlement Authority. 20 I appreciate your time today. 21 You understand you've been retained as an 22 expert witness in this case, correct? 23 A. Correct. 24 Q. And it looks, from your 25 materials, that you've testified many times</p>

<p style="text-align: right;">Page 6</p> <p>1 D. Babbel</p> <p>2 before; is that fair?</p> <p>3 A. Yes.</p> <p>4 Q. So, I won't go through the basic</p> <p>5 rules.</p> <p>6 I want to understand a little bit</p> <p>7 about your background and typically how your</p> <p>8 background relates to your opinions in this</p> <p>9 case.</p> <p>10 A. Yes.</p> <p>11 Q. Let's start with your, your</p> <p>12 non-academic appointments particularly with</p> <p>13 Goldman Sachs. Okay?</p> <p>14 A. Sure.</p> <p>15 Q. What was your role at Goldman</p> <p>16 Sachs, and if it's changed over the period of</p> <p>17 time that you were there, tell me about those</p> <p>18 changes.</p> <p>19 A. Okay. I started off in the fixed</p> <p>20 income division in the financial strategies</p> <p>21 group. And my primary role was to do research</p> <p>22 on the valuation and hedging strategies used</p> <p>23 in fixed income securities.</p> <p>24 I also, while there, did analysis</p> <p>25 of the riskiness of fixed income instruments</p>	<p style="text-align: right;">Page 8</p> <p>1 D. Babbel</p> <p>2 department. But it was mostly relating to</p> <p>3 pension and insurance issues.</p> <p>4 Q. Is it correct that you've never</p> <p>5 been a trader for Goldman Sachs or any other</p> <p>6 entity?</p> <p>7 A. That's correct.</p> <p>8 Q. Have any of your non-academic</p> <p>9 experience related to forward purchase</p> <p>10 agreements?</p> <p>11 A. Have they?</p> <p>12 Q. Yes.</p> <p>13 A. Yes. Certainly, at Goldman Sachs</p> <p>14 we did that. I don't think we did that at</p> <p>15 Frank Russell.</p> <p>16 Q. What was your -- I'm sorry.</p> <p>17 Goldman Sachs --</p> <p>18 A. At the World Bank we didn't do</p> <p>19 that.</p> <p>20 Q. What was your personal</p> <p>21 involvement with respect to forward purchase</p> <p>22 agreements at Goldman Sachs?</p> <p>23 A. Helping to value transactions</p> <p>24 coming up with valuation models that are</p> <p>25 appropriate in particular term structure of</p>
<p style="text-align: right;">Page 7</p> <p>1 D. Babbel</p> <p>2 and their derivatives.</p> <p>3 My second year there I was the</p> <p>4 founding member of the insurance and pension</p> <p>5 department that worked closely with the fixed</p> <p>6 income division, financial strategies.</p> <p>7 We were their major clients</p> <p>8 because the insurance and pension department</p> <p>9 represented the buy side for fixed-income</p> <p>10 securities. And they were the biggest buyer</p> <p>11 that Goldman had.</p> <p>12 I stayed there for a year and</p> <p>13 then returned to the Wharton School. But I</p> <p>14 worked part-time there after.</p> <p>15 Q. What was your part-time</p> <p>16 employment?</p> <p>17 A. I worked part-time at Goldman</p> <p>18 Sachs thereafter.</p> <p>19 Q. I'm sorry. Did you continue in</p> <p>20 the same role in the insurance and pension</p> <p>21 department or did you take on any additional</p> <p>22 role or duties in your part-time work?</p> <p>23 A. Yes, I took on some additional</p> <p>24 duties. I worked with Goldman Sachs asset</p> <p>25 management and also the mortgage securities</p>	<p style="text-align: right;">Page 9</p> <p>1 D. Babbel</p> <p>2 interest, forward rates and spot rates of</p> <p>3 interest.</p> <p>4 I also helped create valuation</p> <p>5 models for derivatives on fixed income</p> <p>6 instruments. And I wrote research papers on</p> <p>7 those.</p> <p>8 Q. In terms of the work you've</p> <p>9 described --</p> <p>10 A. I left off one thing.</p> <p>11 Q. Sure.</p> <p>12 A. With Johnson and Higgins, which</p> <p>13 was the second largest insurance brokerage</p> <p>14 firm at the time, later acquired by Marsh</p> <p>15 Mack, I believe, I worked with the term</p> <p>16 structure of interest and, in particular,</p> <p>17 forward rates and spot rates of interest</p> <p>18 rates. In constructing for them hedges and</p> <p>19 way to price their granted investment</p> <p>20 contracts or GIC's.</p> <p>21 Q. Can we go back now to what you</p> <p>22 described at Goldman Sachs. It sounded like</p> <p>23 you did -- did you do actual programming for</p> <p>24 how to do valuations or -- I'm just trying to</p> <p>25 get a little more depth of what your</p>

<p style="text-align: right;">Page 10</p> <p>1 D. Babbel</p> <p>2 particular involvement -- obviously, you did</p> <p>3 research?</p> <p>4 A. Yes.</p> <p>5 Q. And, in addition to research, it</p> <p>6 sounded like you had some more specific</p> <p>7 involvement in valuation mechanisms; is it</p> <p>8 programming a model or giving advice on</p> <p>9 particular transactions? Can you explain</p> <p>10 that?</p> <p>11 A. Yes, I worked out the</p> <p>12 mathematics. And, in some cases, I did</p> <p>13 programming for valuation. I also produced</p> <p>14 term structures of interest for them. I</p> <p>15 analyzed the volatility of the term structure</p> <p>16 of interest and used those models to assess</p> <p>17 the riskiness of fixed income instruments.</p> <p>18 Q. You used the term in your</p> <p>19 testimony, also in your report, "term</p> <p>20 structure of interest." Can you explain that?</p> <p>21 A. Yes. The term structure of</p> <p>22 interest is a term we use to describe interest</p> <p>23 rates or yields that are available on</p> <p>24 instruments of similar credit risk but of</p> <p>25 different maturities or duration.</p>	<p style="text-align: right;">Page 12</p> <p>1 D. Babbel</p> <p>2 CDs, probably more complicated -- but you</p> <p>3 would get this information from a bank, and</p> <p>4 then you'd obviously do some sort of research</p> <p>5 and valuation of the different term options</p> <p>6 that were available. Is that fair?</p> <p>7 I'm just trying to understand a</p> <p>8 little bit more about what you were doing.</p> <p>9 Obviously you weren't just saying, "Here's the</p> <p>10 rates."</p> <p>11 You were trying to do</p> <p>12 something -- not manipulate -- or provide</p> <p>13 information, point a perspective about those</p> <p>14 rates?</p> <p>15 A. Yes. I'll try to explain better.</p> <p>16 What you see in the marketplace are prices of</p> <p>17 securities and their cousin yields. And those</p> <p>18 yields on the securities are particular to the</p> <p>19 instrument in question and cannot be used to</p> <p>20 value instruments that don't have those</p> <p>21 precise characteristics and exact replicas.</p> <p>22 So what economists do and what</p> <p>23 market participants do is extract financial</p> <p>24 instruments the underlying forward rates and</p> <p>25 underlying spot rates of interest, which in</p>
<p style="text-align: right;">Page 11</p> <p>1 D. Babbel</p> <p>2 Q. Can you give me an example of a,</p> <p>3 of how the term structure of interest would</p> <p>4 have applied to a particular instrument?</p> <p>5 A. Sure. If we go to the bank a</p> <p>6 block away, you can ask them for quotations on</p> <p>7 their certificates of deposit. And they will</p> <p>8 say, we have one rate for six months, another</p> <p>9 rate for one year, another rate for two years.</p> <p>10 We even have a five-year rate. And those will</p> <p>11 be different interest rates depending on how</p> <p>12 long you want to tie up the money.</p> <p>13 Q. So what do you do with that data?</p> <p>14 How do you contribute to the understanding of</p> <p>15 that data?</p> <p>16 A. I don't contribute to the</p> <p>17 understanding of the bank's CDs. But if you</p> <p>18 mean in general how do I contribute to the</p> <p>19 understanding of ...</p> <p>20 Q. Well, for example, as I</p> <p>21 understand your testimony, you provided</p> <p>22 research and advice to Goldman Sachs with</p> <p>23 respect to the term structure of interest.</p> <p>24 So for example, you would see, I</p> <p>25 don't know that Goldman Sachs dealt with bank</p>	<p style="text-align: right;">Page 13</p> <p>1 D. Babbel</p> <p>2 turn, can be used to value anything that has</p> <p>3 cash flows occurring at different times along</p> <p>4 the maturity spectrum. And you have to have</p> <p>5 those fundamental factors to value other</p> <p>6 instruments. And I've written a lot about</p> <p>7 this subject.</p> <p>8 The yields to maturity of one</p> <p>9 instrument cannot be used to, cannot be used</p> <p>10 directly to impute the value of another</p> <p>11 instrument unless it's a clone. Instead you</p> <p>12 have to extract the underlying forward rates</p> <p>13 and spot rates of interest. And those, in</p> <p>14 turn, can be used.</p> <p>15 Q. If I understand you correctly,</p> <p>16 and please correct me if I'm oversimplifying</p> <p>17 or missing the point, you might look at two</p> <p>18 instruments a CD versus a treasury and look at</p> <p>19 the rates that are offered at various periods</p> <p>20 of time and determine from the respective</p> <p>21 rates what particular interest yields might be</p> <p>22 relevant between the two so you can make an</p> <p>23 investment decision about whether you want, if</p> <p>24 you wanted to invest in a series of six-month</p> <p>25 transactions or two-year transactions, which</p>

<p style="text-align: right;">Page 14</p> <p>1 D. Babbel</p> <p>2 of the two instruments is going to be most</p> <p>3 beneficial or highest yielding over time?</p> <p>4 MR. TAMBE: Objection to form.</p> <p>5 You can answer.</p> <p>6 A. I would say "no."</p> <p>7 Q. Okay. Can you explain why "no"?</p> <p>8 MR. TAMBE: Same objection.</p> <p>9 A. That was a long question with a</p> <p>10 lot of parts to it. And I was hanging with</p> <p>11 you for a while, but then you lost me.</p> <p>12 Q. Okay. Where did you hang with</p> <p>13 me?</p> <p>14 A. We were talking about the rates</p> <p>15 of interest and spot rates and forward rates,</p> <p>16 and all of a sudden you injected CDs and</p> <p>17 treasuries into the mix and you weren't</p> <p>18 talking specifically with term rates of</p> <p>19 interest for the, just the yields on those</p> <p>20 instruments.</p> <p>21 Q. I'm trying to understand when</p> <p>22 Goldman Sachs went to you and asked you for</p> <p>23 your research and advice, what were they</p> <p>24 getting in return?</p> <p>25 A. Yes. So I published a lot of</p>	<p style="text-align: right;">Page 16</p> <p>1 D. Babbel</p> <p>2 securities. It was the one at the time that</p> <p>3 seemed to be the most accurate.</p> <p>4 It ended up not mattering very</p> <p>5 much shortly thereafter because we started</p> <p>6 trading zero-coupon bonds in such volume that</p> <p>7 you could look at the term structure directly.</p> <p>8 Q. Meaning that the market</p> <p>9 information was sufficient to determine term</p> <p>10 structure of interest?</p> <p>11 A. Yes. The market information was</p> <p>12 always sufficient to determine it, but you</p> <p>13 have to do more interpolation sometimes than</p> <p>14 others, depending on how dense the market is.</p> <p>15 Zero-coupon bonds gave us a direct measure,</p> <p>16 the term structure of interest.</p> <p>17 Q. Your research in this field</p> <p>18 depends upon market data. Correct?</p> <p>19 A. Yes.</p> <p>20 Q. And it assumes the validity of</p> <p>21 market data for the purposes of the research</p> <p>22 you're doing. Correct?</p> <p>23 MR. TAMBE: Objection to form.</p> <p>24 Q. All I'm trying to get at is when</p> <p>25 someone does research, you have to use data</p>
<p style="text-align: right;">Page 15</p> <p>1 D. Babbel</p> <p>2 that when I was in Goldman Sachs, and it's</p> <p>3 listed in my vitae.</p> <p>4 Q. But it's also fair for me to ask</p> <p>5 these questions. I'd prefer for you to answer</p> <p>6 rather than me read your hundred or so</p> <p>7 publications. If that's okay?</p> <p>8 A. That's a smart approach. They</p> <p>9 were getting insight from me into term</p> <p>10 structure interest, its calculation, more</p> <p>11 efficient ways to calculate it.</p> <p>12 There had been a number of</p> <p>13 approaches to calculate term structure of</p> <p>14 interest. All of them came up with fairly</p> <p>15 similar things. They wanted to understand</p> <p>16 which one was the most accurate and also to do</p> <p>17 research on its volatility over time.</p> <p>18 Q. So did you determine the most</p> <p>19 accurate way to calculate the term structure</p> <p>20 of interest?</p> <p>21 A. I, I was able to assess which one</p> <p>22 was the most usable for them.</p> <p>23 Q. Which was what?</p> <p>24 A. It was, it was called a</p> <p>25 Nelson-Siegel method which is for the Treasury</p>	<p style="text-align: right;">Page 17</p> <p>1 D. Babbel</p> <p>2 points. Correct?</p> <p>3 A. That's correct.</p> <p>4 Q. If I'm going to research</p> <p>5 statistics about baseball, I might use a</p> <p>6 batting average as one data point, or home</p> <p>7 runs, and come up with different calculations</p> <p>8 of how a player performs by manipulating</p> <p>9 available data. Correct?</p> <p>10 A. By studying available data, yes.</p> <p>11 Q. I don't mean for "manipulating"</p> <p>12 to be a bad word. Bill James has come up with</p> <p>13 new statistics based on existing data</p> <p>14 presented in new ways.</p> <p>15 Do you understand that?</p> <p>16 A. Yes.</p> <p>17 Q. And in your world, you're using</p> <p>18 market data, correct, to do your analysis?</p> <p>19 A. I do.</p> <p>20 Q. And you're using market data to</p> <p>21 understand future rates. Is that fair, in</p> <p>22 part?</p> <p>23 A. I -- I use market data to</p> <p>24 understand forward rates.</p> <p>25 Q. And how would you distinguish</p>

<p style="text-align: right;">Page 18</p> <p>1 D. Babbel</p> <p>2 forward rates from future rates?</p> <p>3 A. Forward rates are today's price</p> <p>4 for locking in a new commitment.</p> <p>5 Q. Because the market -- you're not</p> <p>6 using market data to predict future rates.</p> <p>7 You're using market data to understand the</p> <p>8 market as of a given day. Correct?</p> <p>9 A. That's correct.</p> <p>10 Q. And the ability to use market</p> <p>11 data to understand forward rates assumes that</p> <p>12 there's an active market that you can trade</p> <p>13 in. Correct?</p> <p>14 MR. TAMBE: Objection to the form</p> <p>15 of the question.</p> <p>16 Q. In other words, if you're</p> <p>17 deciding about buying T-Bills and you're</p> <p>18 deciding about the different rates that are</p> <p>19 available and the different terms and you're</p> <p>20 analyzing forward rates, you're using market</p> <p>21 data on the assumption that you can then go</p> <p>22 out and transact in T-Bills in the market.</p> <p>23 Correct?</p> <p>24 MR. TAMBE: Same objection.</p> <p>25 A. In both versions of your</p>	<p style="text-align: right;">Page 20</p> <p>1 D. Babbel</p> <p>2 commitments either to buy or to sell.</p> <p>3 The value of an instrument can be</p> <p>4 determined, and is determined, every day on</p> <p>5 Wall Street before the instruments actually</p> <p>6 exist. Because they have market data on</p> <p>7 securities that are traded that gives you an</p> <p>8 understanding of value for some security that</p> <p>9 you're about to issue. And that's --</p> <p>10 Q. Go ahead. I don't want to</p> <p>11 interrupt your answer.</p> <p>12 A. That's sufficient.</p> <p>13 Q. How does current market data tell</p> <p>14 you what the yield on a bond issued by the</p> <p>15 Confederacy is?</p> <p>16 MR. TAMBE: Objection to the form</p> <p>17 of the question.</p> <p>18 A. Which confederacy?</p> <p>19 Q. The South in the civil war.</p> <p>20 A. At its current market data?</p> <p>21 Q. Yeah.</p> <p>22 A. Tell you what it's worth?</p> <p>23 Q. Yeah.</p> <p>24 A. You have to go to the market for</p> <p>25 that. There is a market for those bonds. I</p>
<p style="text-align: right;">Page 19</p> <p>1 D. Babbel</p> <p>2 question, you used the word "you."</p> <p>3 Q. I'm not talking about you,</p> <p>4 personally.</p> <p>5 A. Somebody in the marketplace needs</p> <p>6 to be able to transact.</p> <p>7 Q. So if there was an instrument</p> <p>8 that was no longer available in the market</p> <p>9 upon which to transact and you had data, say,</p> <p>10 from 40 years ago when there was a market for</p> <p>11 an instrument, you wouldn't have any ability</p> <p>12 to understand the current rate structure or</p> <p>13 current value of that asset. Is that fair?</p> <p>14 A. I wouldn't say that.</p> <p>15 Q. Would you explain how you would</p> <p>16 look at the value of that asset where there's</p> <p>17 no market transactions available and no market</p> <p>18 in which to transact on that asset?</p> <p>19 MR. TAMBE: Objection to form.</p> <p>20 You can answer.</p> <p>21 A. The term structure of interest</p> <p>22 tells us the price or the value of cash flows</p> <p>23 received at various points in time. And the</p> <p>24 forward rates and the term structure of</p> <p>25 interest tell us the price of making future</p>	<p style="text-align: right;">Page 21</p> <p>1 D. Babbel</p> <p>2 even have one. And you can trade them. But</p> <p>3 they're collector's items, so that's the</p> <p>4 market for them.</p> <p>5 Q. So in order to understand the</p> <p>6 value of that asset, you would want actual</p> <p>7 market data to inform your value. Correct?</p> <p>8 A. If it's a collector's item, you</p> <p>9 need that. Because there are no cash flows</p> <p>10 associated with the particular bond, since the</p> <p>11 Confederacy is out of operation.</p> <p>12 Q. And what if you don't have market</p> <p>13 data? Let's say people lost interest in</p> <p>14 Confederate bonds, so there hasn't been a</p> <p>15 trade in five years.</p> <p>16 A. Yes.</p> <p>17 Q. How do you bring that into your</p> <p>18 valuation?</p> <p>19 A. For Confederate bonds?</p> <p>20 Q. It could be any. I'm just using</p> <p>21 that as a hypothetical.</p> <p>22 A. Because they offer no payments,</p> <p>23 and they're bought strictly through</p> <p>24 collectors.</p> <p>25 Q. Right.</p>

<p style="text-align: right;">Page 22</p> <p>1 D. Babbel</p> <p>2 A. You have to look at the</p> <p>3 fundamental elements of the security in</p> <p>4 question. And the fundamental elements</p> <p>5 involve cash flows back and forth. Those can</p> <p>6 be valued with term structures of interest</p> <p>7 rates.</p> <p>8 Q. Well, as you said, there's no</p> <p>9 cash flows associated with Confederate bonds</p> <p>10 at this time?</p> <p>11 A. Not that I know of.</p> <p>12 Q. The South will rise again?</p> <p>13 A. Unless South Carolina is doing</p> <p>14 something I don't know about.</p> <p>15 Q. You understand that the RFA</p> <p>16 question in this case is a contract with</p> <p>17 Lehman who went into bankruptcy and rejected</p> <p>18 the contract. Correct?</p> <p>19 A. I understand.</p> <p>20 Q. And so you understand that that</p> <p>21 particular contract is not going to generate</p> <p>22 any cash flows to the rejection date to TSA.</p> <p>23 Right?</p> <p>24 A. That's my understanding.</p> <p>25 Q. And is there some market out</p>	<p style="text-align: right;">Page 24</p> <p>1 D. Babbel</p> <p>2 You can answer.</p> <p>3 A. You switch from a -- the TSA RFA</p> <p>4 which was rejected to a confederacy bond.</p> <p>5 It's my understanding that the TSA retained</p> <p>6 their full \$45 million, and they can invest</p> <p>7 that and earn money on that.</p> <p>8 Whereas, in the confederacy bond</p> <p>9 they didn't get their -- I guess the</p> <p>10 confederacy retained their money, but they had</p> <p>11 it absconded by the federal government.</p> <p>12 Q. Right. So going back to the TSA</p> <p>13 situation. What I understand you said was</p> <p>14 that the TSA got back its \$45 million. Right?</p> <p>15 A. They have it.</p> <p>16 Q. So what you would look at is the</p> <p>17 opportunities the TSA has to invest that \$45</p> <p>18 million to understand what the value is that</p> <p>19 they retained. Correct?</p> <p>20 A. I would say the value they</p> <p>21 retained is \$45 million. That's what they</p> <p>22 have.</p> <p>23 Q. That's what they have now?</p> <p>24 A. Yes, what they do with it.</p> <p>25 That's their business, but they have the</p>
<p style="text-align: right;">Page 23</p> <p>1 D. Babbel</p> <p>2 there for Lehman rejected Reserve Fund</p> <p>3 Agreements that you're aware of?</p> <p>4 A. I'm not a market participant.</p> <p>5 You would need to ask Mr. Gruer about that.</p> <p>6 Q. But, in order to analyze the</p> <p>7 value of that contract, you would want market</p> <p>8 information relevant to that contract.</p> <p>9 Correct?</p> <p>10 MR. TAMBE: Objection to the form</p> <p>11 of the question.</p> <p>12 A. I wouldn't need necessarily</p> <p>13 market information on that particular kind of</p> <p>14 security. What you're looking for is the cash</p> <p>15 flows that would go back and forth and you can</p> <p>16 value those. There are thousands of</p> <p>17 instruments that will provide that.</p> <p>18 Q. But if an instrument is not</p> <p>19 generating a cash flow, it's value is zero</p> <p>20 unless, as you say in the Confederate, there's</p> <p>21 somebody that wants to put one on the wall for</p> <p>22 collector's purposes.</p> <p>23 Is that fair?</p> <p>24 MR. TAMBE: Objection to the form</p> <p>25 of the question.</p>	<p style="text-align: right;">Page 25</p> <p>1 D. Babbel</p> <p>2 money.</p> <p>3 Q. Right. But if you're trying to</p> <p>4 compare what they might have earned under the</p> <p>5 contract with Lehman with guaranteed rate of</p> <p>6 return over a period of time, to what the</p> <p>7 value of that \$45 million is now, you would</p> <p>8 look to the investment opportunities on those</p> <p>9 \$45 million TSA holds and see what they can</p> <p>10 generate from that, consistent with whatever</p> <p>11 restrictions there are on that \$45 million and</p> <p>12 compare it to the guaranteed rate that Lehman</p> <p>13 was to provide.</p> <p>14 Is that fair?</p> <p>15 MR. TAMBE: Object to the form.</p> <p>16 You can answer.</p> <p>17 A. You're focusing on the value of</p> <p>18 something, of a contract that no longer</p> <p>19 exists. To a financial person, the value of</p> <p>20 \$45 million is \$45 million.</p> <p>21 You can put it in pork belly</p> <p>22 futures. You can put it in treasury bonds.</p> <p>23 You can put it in stock. You can put it in</p> <p>24 Egyptian junk. It's still \$45 million.</p> <p>25 That's what the value is. That's the end of</p>

<p style="text-align: right;">Page 26</p> <p>1 D. Babbel</p> <p>2 that story.</p> <p>3 Now, in terms of -- so that's the</p> <p>4 present value, \$45 million. What TSA happens</p> <p>5 to do with that money is TSA's business.</p> <p>6 Q. Fair enough. So as I understand</p> <p>7 it in pretty straightforward terms: The value</p> <p>8 of the \$45 million of the TSA Reserve Fund</p> <p>9 Agreement to date was the \$45 million that the</p> <p>10 TSA had in hand to do with what it thought</p> <p>11 best?</p> <p>12 MR. TAMBE: Objection to the form</p> <p>13 of the question.</p> <p>14 You can answer.</p> <p>15 A. That's the value of the amount of</p> <p>16 the money they have now. If the contract was</p> <p>17 so-called in the money or out of the money --</p> <p>18 if the contract was in the money, in favor of</p> <p>19 TSA, they would have lost some portion because</p> <p>20 they entered into the agreement back in</p> <p>21 2002.</p> <p>22 By 2009, things had changed. And</p> <p>23 so they may have had -- they may have been in</p> <p>24 the money or maybe Lehman was in the money,</p> <p>25 and that would be the only piece. In addition</p>	<p style="text-align: right;">Page 28</p> <p>1 D. Babbel</p> <p>2 value calculation, what would you use to</p> <p>3 discount the total payments over time to the</p> <p>4 present value?</p> <p>5 MR. TAMBE: Which payments?</p> <p>6 Q. The interest payments that Lehman</p> <p>7 was supposed to make over the every-six-months</p> <p>8 in the remaining twenty years of the RFA?</p> <p>9 A. It would depend on the security</p> <p>10 of those payments.</p> <p>11 Q. What do you mean by "the security</p> <p>12 of those payments"?</p> <p>13 A. Well, if the Treasury, or</p> <p>14 something better than the Treasury, were</p> <p>15 offering me 4.484 percent on \$45 million, that</p> <p>16 would have a value higher than if someone that</p> <p>17 couldn't print money were offering it to me.</p> <p>18 Q. Well, Lehman was the one who was</p> <p>19 obligated to make the payment. Obviously,</p> <p>20 they're not going to make the payment. So is</p> <p>21 there a way -- so maybe I'm missing your</p> <p>22 point.</p> <p>23 But there is a way we can</p> <p>24 calculate the number of dollars that Lehman</p> <p>25 was supposed to pay over the remaining term of</p>
<p style="text-align: right;">Page 27</p> <p>1 D. Babbel</p> <p>2 to the \$45 million, that would either be added</p> <p>3 or subtracted to it, to come up with the</p> <p>4 value.</p> <p>5 Q. Now, you could do a net present</p> <p>6 value calculation of the interest that TSA was</p> <p>7 supposed to earn from the date of rejection to</p> <p>8 the end date of the contract. Correct?</p> <p>9 A. In that present value of the</p> <p>10 interest.</p> <p>11 Q. Of the interest payments that</p> <p>12 were guaranteed under the contract?</p> <p>13 A. You could calculate a present</p> <p>14 value of the interest. But a net present</p> <p>15 value, you have to pay for that. It's 45</p> <p>16 million.</p> <p>17 Q. Forget the word "net."</p> <p>18 A. Okay.</p> <p>19 Q. So you could add up the interest</p> <p>20 payments that were supposed to be paid every</p> <p>21 six months on that contract over the rejection</p> <p>22 date and reduce that to a present value. Is</p> <p>23 that more accurate?</p> <p>24 A. Yes.</p> <p>25 Q. And if you were doing a present</p>	<p style="text-align: right;">Page 29</p> <p>1 D. Babbel</p> <p>2 the agreements. Correct?</p> <p>3 A. That's correct.</p> <p>4 Q. And if I wanted to discount that</p> <p>5 to present value, how would you do that?</p> <p>6 A. It would depend, as I said, on</p> <p>7 who the counterparty is, who is going to make</p> <p>8 those payments.</p> <p>9 Q. Right now, there's no</p> <p>10 counterparty who is going to make those</p> <p>11 payments?</p> <p>12 A. That's right.</p> <p>13 Q. So what assumption would you make</p> <p>14 in order to do present value calculation in</p> <p>15 the sum of those payments?</p> <p>16 A. Well, I wouldn't assume the</p> <p>17 federal government is going to pay it. So</p> <p>18 you're going to have some other party -- you</p> <p>19 would look at the nonfederal government analog</p> <p>20 to that to be the fixed leg of a swap.</p> <p>21 Q. So what would your best opinion</p> <p>22 be about what you would look to? Are you</p> <p>23 talking about LIBOR? Are we talking about</p> <p>24 some other index? Are we talking about the</p> <p>25 rate of return that TSA was actually receiving</p>

<p style="text-align: right;">Page 30</p> <p>1 D. Babbel</p> <p>2 for a period of time? How would you figure</p> <p>3 that out?</p> <p>4 MR. TAMBE: Object to the form.</p> <p>5 You can answer.</p> <p>6 A. It really depends upon the damage</p> <p>7 theory, I suppose. I wasn't retained as an</p> <p>8 expert on damages, and I haven't thought about</p> <p>9 damages.</p> <p>10 The focus of my testimony is</p> <p>11 whether forward rates of interest are used in</p> <p>12 valuing swaps. So I don't have an opinion.</p> <p>13 It depends on the damage theory that the</p> <p>14 courts decide is appropriate in this case.</p> <p>15 Q. Explain that to me. What about</p> <p>16 the damage theory would inform your decision</p> <p>17 on how to discount a current value?</p> <p>18 MR. TAMBE: Objection to the form</p> <p>19 of the question.</p> <p>20 A. Your hypothetical -- your</p> <p>21 question is looking at a series of future</p> <p>22 payments according to reports, the next 23</p> <p>23 years or so, whatever remains of that. And</p> <p>24 you want me to come up with -- you're asking</p> <p>25 how would I come up with a present value.</p>	<p style="text-align: right;">Page 32</p> <p>1 D. Babbel</p> <p>2 Q. Because you're saying you can't</p> <p>3 find the counterparty?</p> <p>4 A. Right. So that's not Lehman's</p> <p>5 fault. Now, were you in the money or out of</p> <p>6 the money when Lehman -- that contract, that's</p> <p>7 your focus. Right?</p> <p>8 Q. Well, that's not my question.</p> <p>9 But obviously that's a focus of this</p> <p>10 litigation.</p> <p>11 My question for you is: We know</p> <p>12 what the fixed leg payments from Lehman were</p> <p>13 supposed to be over those 23 years. Correct?</p> <p>14 A. We do. We don't know that it was</p> <p>15 over 23 years, but --</p> <p>16 Q. Yes --</p> <p>17 MR. TAMBE: Let him ask his</p> <p>18 question. You're talking over each</p> <p>19 other.</p> <p>20 Q. You do understand that it's</p> <p>21 appropriate, when looking at that number, to</p> <p>22 do a present value discount to understand what</p> <p>23 that payment stream is worth today as part of</p> <p>24 a damage calculation. Correct?</p> <p>25 A. To the extent that damage</p>
<p style="text-align: right;">Page 31</p> <p>1 D. Babbel</p> <p>2 Q. Exactly.</p> <p>3 A. It's inextricably linked to the</p> <p>4 damage theory. You want to -- you talk about</p> <p>5 one leg of a transaction and if it were</p> <p>6 replaced. But if it were replaced, it would</p> <p>7 involve a counterparty.</p> <p>8 There are no counterparties out</p> <p>9 there for it, apparently, at least in your</p> <p>10 hypothetical. And if there are no</p> <p>11 counterparties out there available to make</p> <p>12 those payments, why aren't there?</p> <p>13 Because there are counterparties</p> <p>14 out there. There are hundreds of</p> <p>15 counterparties out there for streams of</p> <p>16 payments.</p> <p>17 Is it because Washington Tobacco</p> <p>18 is not a good counterparty? Did they</p> <p>19 deteriorate? Did that entire industry</p> <p>20 deteriorate?</p> <p>21 It had nothing to do with Lehman</p> <p>22 Brothers. There's some reason that these</p> <p>23 hundred or thousand potential counterparties</p> <p>24 aren't taking that side with Washington.</p> <p>25 You're saying --</p>	<p style="text-align: right;">Page 33</p> <p>1 D. Babbel</p> <p>2 calculation involves values, yes.</p> <p>3 Q. So I'm now looking to you,</p> <p>4 Professor Babbel, to help me figure out what</p> <p>5 the appropriate mechanism to discount the</p> <p>6 present value is.</p> <p>7 MR. TAMBE: Objection to form.</p> <p>8 Asked and answered.</p> <p>9 You can answer.</p> <p>10 A. I'm trying to see what I can say,</p> <p>11 what I haven't already. Because you're</p> <p>12 talking about a series of cash flows over 23</p> <p>13 years, and the value of it obviously depends</p> <p>14 upon the counterparty. And you're saying</p> <p>15 there isn't a counterparty, and it has no</p> <p>16 value.</p> <p>17 So, putting that aside, what's</p> <p>18 the best you can do -- the second best you can</p> <p>19 do since you have no counterparty? That is to</p> <p>20 use the market for similar sorts of cash</p> <p>21 flows, and I would use the LIBOR curve to</p> <p>22 value that.</p> <p>23 Q. Now, in this situation, because</p> <p>24 there are no counterparties out there willing</p> <p>25 to step into the contract, does that</p>

<p style="text-align: right;">Page 34</p> <p>1 D. Babbel</p> <p>2 complicate the valuation exercise?</p> <p>3 MR. TAMBE: Objection to the form</p> <p>4 of the question.</p> <p>5 A. You're stipulating that there are</p> <p>6 none because that was an assumption earlier.</p> <p>7 Now, you're stipulating?</p> <p>8 Q. Well, Lehman's expert has</p> <p>9 testified that there was no active market in</p> <p>10 March of 2009 for these types of agreements.</p> <p>11 A. Yes.</p> <p>12 Q. So I don't know that that's in</p> <p>13 the form of a stipulation. But I will ask you</p> <p>14 to take that as an assumption for my question.</p> <p>15 A. Okay.</p> <p>16 MR. TAMBE: What's the question</p> <p>17 again?</p> <p>18 Q. What complications does that</p> <p>19 create for valuing a contract when there's no</p> <p>20 counterparty available to step in, no market</p> <p>21 participant who's willing to enter into this</p> <p>22 contract?</p> <p>23 A. Yes.</p> <p>24 MR. TAMBE: Objection to the form</p> <p>25 of that question.</p>	<p style="text-align: right;">Page 36</p> <p>1 D. Babbel</p> <p>2 Q. That's the present value of what</p> <p>3 TSA has?</p> <p>4 A. Yes. They're giving that to</p> <p>5 somebody else. And if you're looking at what</p> <p>6 they could earn from it, presumably they could</p> <p>7 earn market rates. And if you discount by</p> <p>8 market rates, you got \$45 million.</p> <p>9 That's assuming that they get not</p> <p>10 only the interest on it but also the</p> <p>11 principal. If they don't get the principal,</p> <p>12 then you just calculate the interest rate you</p> <p>13 could get on it.</p> <p>14 Q. So actually, present value is</p> <p>15 simply looking at the interest earned over</p> <p>16 time and returning now to the present. And as</p> <p>17 you said, IPOs de facto with that \$45 million,</p> <p>18 it goes back to \$45 million as the present</p> <p>19 value. Correct?</p> <p>20 MR. TAMBE: Objection to the form</p> <p>21 of the question.</p> <p>22 You can answer.</p> <p>23 A. If you go to not only the</p> <p>24 interest stream but also the principal, yes,</p> <p>25 then it's worth 45 million.</p>
<p style="text-align: right;">Page 35</p> <p>1 D. Babbel</p> <p>2 A. It does not eliminate the ability</p> <p>3 to calculate a present value using LIBOR</p> <p>4 rates, which I understand would have been used</p> <p>5 when the contract was initially set up and</p> <p>6 which continued to exist in rich measure. So</p> <p>7 you can value it with LIBOR rates, as I said.</p> <p>8 Q. In terms of the -- so we're</p> <p>9 talking about the, sort of, fixed rate of the</p> <p>10 transaction that has failed. In terms of the</p> <p>11 floating leg of the transaction, I think you</p> <p>12 testified earlier that TSA has its \$45</p> <p>13 million. Correct?</p> <p>14 A. Yes.</p> <p>15 Q. And it has the ability to invest</p> <p>16 that. Correct?</p> <p>17 A. It does.</p> <p>18 Q. And in terms of looking at what</p> <p>19 that floating leg would be worth, you would</p> <p>20 look at what the investment options are for</p> <p>21 TSA with that \$45 million.</p> <p>22 Is that fair?</p> <p>23 A. To see what that's worth?</p> <p>24 Q. Yes.</p> <p>25 A. No. It's worth \$45 million.</p>	<p style="text-align: right;">Page 37</p> <p>1 D. Babbel</p> <p>2 Q. I think we're all assuming that</p> <p>3 the principal would be there at the end.</p> <p>4 A. Uh-huh.</p> <p>5 Q. So we actually got off on this,</p> <p>6 talking about your nonacademic experience. I</p> <p>7 just want to finish up on that area.</p> <p>8 You indicated you were not a</p> <p>9 trader. Did you ever participate in any way</p> <p>10 with respect to valuations of the Reserve Fund</p> <p>11 Agreement?</p> <p>12 A. No.</p> <p>13 Q. Did you have any involvement in</p> <p>14 any way with --</p> <p>15 A. Well, I'm sorry, I shouldn't say</p> <p>16 that. I should say I didn't. I didn't</p> <p>17 participate in any way in the values of</p> <p>18 research fund agreements associated with</p> <p>19 tobacco settlements. As for whether I ever</p> <p>20 worked with reserve agreements apart from</p> <p>21 tobacco, I don't recall.</p> <p>22 Q. And my next question was going to</p> <p>23 be tobacco related. If I understand your</p> <p>24 testimony, you didn't have any involvement in</p> <p>25 Tobacco-related Reserve Fund Agreements. Is</p>

<p style="text-align: right;">Page 38</p> <p>1 D. Babbel</p> <p>2 that correct?</p> <p>3 A. That's correct.</p> <p>4 Q. Did you have any involvement at</p> <p>5 all in analyzing the tobacco master settlement</p> <p>6 and payments to estates in any way?</p> <p>7 A. No.</p> <p>8 Q. And you don't recall one way or</p> <p>9 another whether you had any involvement in</p> <p>10 other types of Reserve Fund Agreements. Is</p> <p>11 that correct?</p> <p>12 A. That's correct.</p> <p>13 Q. In your academic experience, did</p> <p>14 you do any writing or research with respect to</p> <p>15 Tobacco RFAs?</p> <p>16 A. No.</p> <p>17 Q. Did you do any writing or</p> <p>18 research with respect to the Tobacco Master</p> <p>19 Settlement Agreements and payments to the</p> <p>20 estates from that?</p> <p>21 A. No.</p> <p>22 Q. Do you recall doing any research</p> <p>23 and writing with respect to Reserve Fund</p> <p>24 Agreements, generally?</p> <p>25 MR. TAMBE: Object to the form.</p>	<p style="text-align: right;">Page 40</p> <p>1 D. Babbel</p> <p>2 every asset treated on Wall Street.</p> <p>3 So to characterize those as</p> <p>4 insurance instruments, well, they're financial</p> <p>5 instruments. Insurance companies happen to</p> <p>6 buy them.</p> <p>7 Q. And I didn't mean to distinguish</p> <p>8 that you didn't write more broadly about</p> <p>9 insurance.</p> <p>10 A. Okay.</p> <p>11 Q. Your -- the focus of your opinion</p> <p>12 here is on the future curve. Correct?</p> <p>13 MR. TAMBE: Objection to the form</p> <p>14 of the question.</p> <p>15 Q. Forward curve. Sorry.</p> <p>16 A. Yes.</p> <p>17 Q. And your opinion is about the</p> <p>18 fact that the forward curve is a valid tool to</p> <p>19 use in the market. Correct?</p> <p>20 A. Yes.</p> <p>21 Q. Are there -- and I understand</p> <p>22 that your research and publications may touch</p> <p>23 on that. But are there any particular</p> <p>24 research publications that you've listed that</p> <p>25 would talk most directly about the forward</p>
<p style="text-align: right;">Page 39</p> <p>1 D. Babbel</p> <p>2 You can answer.</p> <p>3 A. To me, from a description of cash</p> <p>4 flows that respective -- it's not, Reserve</p> <p>5 Fund Agreements are different from,</p> <p>6 fundamentally different from other sorts of</p> <p>7 swap arrangements.</p> <p>8 Q. And that's a fair answer. But,</p> <p>9 for example, you can look at your CV. You've</p> <p>10 written a lot about insurance instruments.</p> <p>11 Correct?</p> <p>12 A. Yes.</p> <p>13 Q. And I understand that your</p> <p>14 research and writing may pertain to Reserve</p> <p>15 Fund Agreements. But that's not my question.</p> <p>16 My question is: Are any of your</p> <p>17 research or articles focused specifically on</p> <p>18 Reserve Fund Agreements as an instrument?</p> <p>19 A. No. I would add that you said a</p> <p>20 lot of my writing refers to insurance</p> <p>21 instruments. But insurance instruments --</p> <p>22 insurance companies have assets and</p> <p>23 liabilities. So I have written papers on</p> <p>24 virtually every kind of asset that an</p> <p>25 insurance company has, which is virtually</p>	<p style="text-align: right;">Page 41</p> <p>1 D. Babbel</p> <p>2 curve and its use in the market?</p> <p>3 MR. TAMBE: Objection to the form</p> <p>4 of the question.</p> <p>5 You can answer.</p> <p>6 A. I'd have to take a look.</p> <p>7 MR. LAWRENCE: Let's mark your</p> <p>8 report and do that.</p> <p>9 (Babbel Exhibit 1, Report of</p> <p>10 David F. Babbel, marked for</p> <p>11 identification, as of this date.)</p> <p>12 A. Can I mark on this? Does that</p> <p>13 make it easier?</p> <p>14 Q. If I give you the okay to mark on</p> <p>15 it, it's okay to mark on it.</p> <p>16 For now, let me first of all ask:</p> <p>17 Is that your expert report in this matter?</p> <p>18 A. It looks like it, yes.</p> <p>19 Q. So starting on page 22. You have</p> <p>20 many pages of research papers that you've</p> <p>21 conducted. And as much as I would love to</p> <p>22 read all of them, I'm asking you if you can</p> <p>23 identify -- and maybe the answer to that --</p> <p>24 there are none that are particularly focused</p> <p>25 on the forward curve. But if you could</p>

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<p>1 D. Babbel 2 identify a couple that you think are 3 particularly focused on your view of the 4 forward curve, that would be appreciated. 5 MR. TAMBE: Objection to the form 6 of the question. 7 You can answer. 8 And just so you know, Paul, we 9 need to take a break at 11:15, about 20 10 minutes from now. 11 MR. LAWRENCE: That's fine. 12 MR. TAMBE: So you can plan 13 accordingly. 14 A. May I mark on page 22? 15 Q. Yes, that would be fine. 16 A. Okay. 17 Q. Just, you have to tell me what 18 you're -- 19 A. (Document review.) "Evaluating 20 Pension Insurance Pricing." "In technical 21 review," this is for the government. 22 MR. TAMBE: Well, he's going to 23 tell you enough so you know what he's 24 marking. 25 MR. LAWRENCE: Exactly.</p>	<p>1 D. Babbel 2 is it a collection? 3 A. No. We're the sole authors. I 4 wrote all but two chapters. But he is a 5 president of the Federal Reserve Bank, so he 6 thought his name would sell more books. 7 I don't know about 8 "Asset/Liability Management for Insurers in 9 the New Era." "Inverse Floaters," that would 10 definitely have something about it. 11 "Valuation of Interest-Sensitive Financial 12 Instruments," that's a book that I wrote 13 together with Craig Merrill. 14 Q. I don't want to stop you if you 15 need to you go back before 2000, but I was 16 interested in your more recent writing. 17 A. Some of the best is yet to come. 18 This investment managers for insurers, I can't 19 be sure, but that was an he did volume. So, I 20 wrote three or four papers in that book. 21 Q. Why don't we call it a day there. 22 And if I need to go back -- 23 A. I know there are a bunch back in 24 the '70s and '80s. 25 Q. If there's something specific</p>
Page 43	Page 45
<p>1 D. Babbel 2 Q. I would say you don't have to go 3 back before 2002. 4 A. On page 23, it's "Extracting 5 Probabilistic Information from the Price of 6 Interest Rate Options" from the Journal of 7 Business paper. 8 Very relevant would be "The Price 9 Pressure Hypothesis and Off-the-Run Treasury 10 Bonds." 11 Q. What page are you on? 12 A. Twenty-four. 13 (Document review.) I'm sure to a 14 financial economist the next three papers 15 would be relevant. 16 Q. The three "Fair Value of 17 Liabilities"? 18 A. Yes. 19 (Document review.) I don't know 20 about the "Financial Engineering and 21 Structured Products." 22 The "Financial Markets, 23 Instruments and Institutions" is very 24 relevant. 25 Q. Are you two the sole authors, or</p>	<p>1 D. Babbel 2 that you want to point to -- I'm just trying 3 to avoid you having to go through every 4 particular option. 5 A. Sure, there's one. In the back. 6 I guess the first time I wrote 7 about it was actually my doctoral 8 dissertation. That's 1978. That's one of the 9 books. So that would be inflation and 10 indexation. So that uses forward rates. 11 And I also have another important 12 one in 1983, approximately; which is, 13 "Duration and the Term Structure of Interest 14 Rate Volatility." That paper led to my hiring 15 by Goldman Sachs. 16 "Real Immunization with Index 17 Bonds," 1984, that was me showing how to value 18 index bonds before they existed, using forward 19 curves and spot curves. 20 "The Term Structure of Interest 21 Rate Volatility: A Binational Comparison" -- 22 anyway, that's enough. There are probably 23 about ten more. So I have maybe 20 papers 24 total. 25 Q. Thank you.</p>

<p style="text-align: right;">Page 46</p> <p>1 D. Babbel</p> <p>2 So, you've testified in quite a</p> <p>3 number of cases in the past four years as</p> <p>4 identified in your disclosure.</p> <p>5 Is that fair?</p> <p>6 A. Yes. I left off the most</p> <p>7 important one, that's a journal, "Financial</p> <p>8 Engineering."</p> <p>9 MR. TAMBE: Going back to the</p> <p>10 articles?</p> <p>11 THE WITNESS: Yes.</p> <p>12 A. Let's see when that was. It even</p> <p>13 has forward in the title of the paper.</p> <p>14 Q. It looks like on page 26 it's</p> <p>15 talking about quantity-adjusting options and</p> <p>16 forward contracts?</p> <p>17 A. Yes.</p> <p>18 Q. Okay. Thank you.</p> <p>19 What percentage of your time over</p> <p>20 the past four years have been spent doing</p> <p>21 expert witness work?</p> <p>22 A. Maybe 15 percent. That's a broad</p> <p>23 guess.</p> <p>24 Q. And you've listed a number of</p> <p>25 cases that you've been involved in. I want to</p>	<p style="text-align: right;">Page 48</p> <p>1 D. Babbel</p> <p>2 floating rate instruments and perpetual</p> <p>3 floaters, and the tax implications.</p> <p>4 Q. What was the subject of your</p> <p>5 expert testimony?</p> <p>6 A. On the floating rate instruments</p> <p>7 and their value and whether that value was</p> <p>8 correctly assigned to the tax elements.</p> <p>9 Q. So how -- part of your testimony</p> <p>10 related to the proper method to value certain</p> <p>11 floating rate instruments. Is that right?</p> <p>12 A. Yes.</p> <p>13 Q. What floating rate instruments</p> <p>14 did you opine about in terms of value?</p> <p>15 A. Perpetual floaters and when they</p> <p>16 were divided into certain tranches: a forward</p> <p>17 tranche and a present tranche.</p> <p>18 Q. Did the valuation methodology</p> <p>19 differ depending upon whether you were valuing</p> <p>20 the forward tranche versus the present</p> <p>21 tranche?</p> <p>22 A. No. It's the same methodology.</p> <p>23 Q. And what is the methodology that</p> <p>24 you advocated for in terms of valuing these</p> <p>25 perpetual floating rate instruments?</p>
<p style="text-align: right;">Page 47</p> <p>1 D. Babbel</p> <p>2 go over a few of those at least briefly.</p> <p>3 A. Sure.</p> <p>4 Q. The first is Salty Brine 1 v.</p> <p>5 United States of America.</p> <p>6 Do you recall testifying as an</p> <p>7 expert in that case?</p> <p>8 A. Yes.</p> <p>9 Q. What side did you testify for?</p> <p>10 A. The government.</p> <p>11 Q. And what was the nature of the</p> <p>12 dispute there?</p> <p>13 A. It involved phantom insurance</p> <p>14 policies and tax avoidance.</p> <p>15 Q. And did your testimony in that</p> <p>16 case involve the validity of the forward</p> <p>17 curve?</p> <p>18 A. No.</p> <p>19 Q. Next case is Principal Life</p> <p>20 Insurance Company v. USA. Which side did you</p> <p>21 testify there?</p> <p>22 A. Principal Life.</p> <p>23 Q. And what generally was the</p> <p>24 dispute?</p> <p>25 A. It related to the valuation of</p>	<p style="text-align: right;">Page 49</p> <p>1 D. Babbel</p> <p>2 A. Well, in both cases, you use the</p> <p>3 term "structure of interest," the spot and</p> <p>4 forward rates to value them.</p> <p>5 Q. Would those instruments that</p> <p>6 could be transacted in the market at the time</p> <p>7 that was in dispute, the time of valuation?</p> <p>8 A. The market had deteriorated for</p> <p>9 those instruments, but they could still be</p> <p>10 valued.</p> <p>11 Q. And how did you value them in a</p> <p>12 deteriorating market?</p> <p>13 A. You could still value them with</p> <p>14 the underpinning spot and forward rate curves.</p> <p>15 Q. And were you looking at the spot</p> <p>16 and forward rate curves for those particular</p> <p>17 instruments, or were you looking for the</p> <p>18 curves -- the spot and forward rate curves for</p> <p>19 what you opined were like instruments?</p> <p>20 MR. TAMBE: Objection to the form</p> <p>21 of the question.</p> <p>22 A. I don't recall. It was, like,</p> <p>23 years ago, or something.</p> <p>24 Q. Do you recall how that case was</p> <p>25 resolved?</p>

<p style="text-align: right;">Page 50</p> <p>1 D. Babbel</p> <p>2 A. The Internal Revenue Service</p> <p>3 stopped -- stopped all action. I don't know</p> <p>4 why.</p> <p>5 Q. Okay.</p> <p>6 A. And I don't know if it's going to</p> <p>7 resume at some point.</p> <p>8 Q. The next case listed is Razorback</p> <p>9 Funding v. Scott Rothstein. What side were</p> <p>10 you on in that case?</p> <p>11 A. TD Bank.</p> <p>12 Q. And what was the nature of the</p> <p>13 dispute?</p> <p>14 A. It was a Ponzi scheme related to</p> <p>15 sexual harassment claims where there were no</p> <p>16 victims or claimants. It was all fictitious.</p> <p>17 Q. And what was the nature of your</p> <p>18 testimony?</p> <p>19 A. I looked at the rates of return</p> <p>20 that were promised, which were somewhere</p> <p>21 between 800 percent and 5,000 percent over a</p> <p>22 three-month time period, and then suggested</p> <p>23 that sophisticated investors might think that</p> <p>24 there's something awry to have a risk-free</p> <p>25 investment that was offering those sorts of</p>	<p style="text-align: right;">Page 52</p> <p>1 D. Babbel</p> <p>2 A. On the appropriate pricing of the</p> <p>3 life settlements.</p> <p>4 Q. Now, you use the term pricing</p> <p>5 rather than valuation. Is that an intentional</p> <p>6 distinction in your mind?</p> <p>7 A. No.</p> <p>8 Q. And how did you go about valuing</p> <p>9 the pricing of the life settlements?</p> <p>10 A. Well, I think that would take the</p> <p>11 rest of the deposition, a lot of time to go</p> <p>12 through that.</p> <p>13 Q. Did it involve the use of spot</p> <p>14 and forward rates?</p> <p>15 A. We certainly used spot rates.</p> <p>16 Q. We can move on then.</p> <p>17 MR. TAMBE: Is this a good time?</p> <p>18 It's almost 11:15. I just need to take</p> <p>19 a break for a call.</p> <p>20 MR. LAWRENCE: Sure.</p> <p>21 (Recess taken from 11:13 a.m. to</p> <p>22 11:36 a.m.)</p> <p>23 BY MR. LAWRENCE:</p> <p>24 Q. We were going through the cases</p> <p>25 in which you had testified, and the next case</p>
<p style="text-align: right;">Page 51</p> <p>1 D. Babbel</p> <p>2 rates.</p> <p>3 Q. Okay. Let's move to Claston, LLC</p> <p>4 v. USA. What side did you testify for in that</p> <p>5 case, if you recall?</p> <p>6 A. I don't remember that.</p> <p>7 Q. Claston, LLC, by and through</p> <p>8 Sunset Holdings, LLC v. USA?</p> <p>9 A. Okay. I was on the USA side.</p> <p>10 Q. And what was the nature of that</p> <p>11 dispute?</p> <p>12 A. That was fraudulent taxation.</p> <p>13 Q. What was the nature of your</p> <p>14 testimony?</p> <p>15 A. That it was fraudulent.</p> <p>16 Q. Ritchie Risk-Linked Strategies</p> <p>17 Trading v. Coventry First, LLC. What side</p> <p>18 were you on?</p> <p>19 A. Coventry.</p> <p>20 Q. What was the nature of that</p> <p>21 dispute?</p> <p>22 A. That was on the sale of life</p> <p>23 settlements to a hedge fund.</p> <p>24 Q. And what was the nature of your</p> <p>25 expert testimony?</p>	<p style="text-align: right;">Page 53</p> <p>1 D. Babbel</p> <p>2 identified by counsel for Lehman is Kim Nolte,</p> <p>3 Sherry Lewis on behalf of the CIGNA 401(k)</p> <p>4 plan v. CIGNA.</p> <p>5 Do you recall that case?</p> <p>6 A. Yes.</p> <p>7 Q. Which side did you testify for?</p> <p>8 A. On the side of CIGNA.</p> <p>9 Q. And what was the nature of the</p> <p>10 dispute?</p> <p>11 A. It had to do with the stable</p> <p>12 value investment fund and whether the rates</p> <p>13 generated were appropriate for their 401(k)</p> <p>14 plans.</p> <p>15 Q. And what was the nature of your</p> <p>16 testimony?</p> <p>17 A. They actually were better than</p> <p>18 just about any player in that market.</p> <p>19 Q. In terms of the rates that were</p> <p>20 being offered?</p> <p>21 A. Yes.</p> <p>22 Q. The next case is World Holdings,</p> <p>23 LLC v. Federal Republic of Germany. What side</p> <p>24 did you testify on behalf of?</p> <p>25 A. World Holdings.</p>

<p style="text-align: right;">Page 54</p> <p>1 D. Babbel</p> <p>2 Q. And what was the nature of that</p> <p>3 dispute?</p> <p>4 A. Gold bonds.</p> <p>5 Q. And was the nature of your</p> <p>6 testimony?</p> <p>7 A. What their value would be in</p> <p>8 today's dollars. They were from the pre-Nazi</p> <p>9 era.</p> <p>10 Q. Similar to the Confederacy issue?</p> <p>11 A. No, because they actually have</p> <p>12 backing and the governments are paying.</p> <p>13 Q. What was your testimony as far as</p> <p>14 how you go about valuing these bonds?</p> <p>15 A. Well, they were linked to gold</p> <p>16 prices. So I just looked at what the promises</p> <p>17 were and the language, and I could value it.</p> <p>18 Q. So there was no -- strike that.</p> <p>19 Did you look at a valuation as of</p> <p>20 a particular date or a valuation -- strike</p> <p>21 that.</p> <p>22 Did you look at valuation into</p> <p>23 the future at all?</p> <p>24 A. No.</p> <p>25 Q. So all the gold price data that</p>	<p style="text-align: right;">Page 56</p> <p>1 D. Babbel</p> <p>2 when the market knew about the insolvency and</p> <p>3 what the prices were at that time, that</p> <p>4 moment. Whatever the instruments were, I</p> <p>5 forget.</p> <p>6 Q. How did you go about determining</p> <p>7 when the market knew about the Lehman</p> <p>8 bankruptcy?</p> <p>9 A. Well, we looked for the reports</p> <p>10 that came out at that time. And it was</p> <p>11 important, actually, what hour of the day when</p> <p>12 it went across the wires, and so we diagnosed</p> <p>13 all of that.</p> <p>14 Q. So do I understand you were</p> <p>15 trying to find a minute, so-to-speak, in time</p> <p>16 when the market was informed about the Lehman</p> <p>17 bankruptcy in order to look at the price, I</p> <p>18 guess, immediately before that?</p> <p>19 A. I don't remember that. But I do</p> <p>20 remember that we had to look at a very fine</p> <p>21 amount of time. So I don't remember if it was</p> <p>22 a minute before, a minute after, or whatever.</p> <p>23 Q. You're trying to find what the</p> <p>24 market conditions -- what the market value of</p> <p>25 these instruments were at that moment in time?</p>
<p style="text-align: right;">Page 55</p> <p>1 D. Babbel</p> <p>2 you utilized was known and verified from</p> <p>3 actual market transactions. Correct?</p> <p>4 A. It was.</p> <p>5 Q. The next case is Individual</p> <p>6 Investors v. Bankinter -- B-a-n-k-i-n-t-e-r</p> <p>7 S-a?</p> <p>8 A. Yes.</p> <p>9 Q. And which side did you testify</p> <p>10 for?</p> <p>11 A. On the side of Bankinter.</p> <p>12 Q. What was the nature of the</p> <p>13 dispute?</p> <p>14 A. It had to do with the insolvency</p> <p>15 of Lehman Brothers and what kind of remedial</p> <p>16 actions that plaintiffs should take, and as of</p> <p>17 what date they should take them.</p> <p>18 Q. What was the role of -- how did</p> <p>19 Lehman play in that case?</p> <p>20 A. Just the investors had purchased</p> <p>21 some funds through Bankinter from Lehman</p> <p>22 Brothers.</p> <p>23 Q. And what was the nature of your</p> <p>24 testimony?</p> <p>25 A. It was just establishing the time</p>	<p style="text-align: right;">Page 57</p> <p>1 D. Babbel</p> <p>2 A. Yes.</p> <p>3 Q. Again, you were looking at actual</p> <p>4 market data from the past rather than</p> <p>5 predictive market data for the future.</p> <p>6 Correct?</p> <p>7 MR. TAMBE: Objection to the</p> <p>8 form.</p> <p>9 You can answer.</p> <p>10 A. I don't know that. As I sit</p> <p>11 here, it seemed to me the markets were very</p> <p>12 thin, and I can't remember what we had to do</p> <p>13 in this case, if we had to interpolate or</p> <p>14 what. I just don't remember. But it's in</p> <p>15 Spanish.</p> <p>16 Q. Did you testify in Spanish?</p> <p>17 A. My testimony is in Spanish. I'm</p> <p>18 fluent in Portuguese, but I wrote it in</p> <p>19 English. It was translated by an official</p> <p>20 translator, and that's all I know.</p> <p>21 Q. Ormande v. Anthem, Inc. What</p> <p>22 side did you testify on behalf of?</p> <p>23 A. The class, Ormande.</p> <p>24 Q. And what was the nature of the</p> <p>25 dispute?</p>

<p style="text-align: right;">Page 58</p> <p>1 D. Babbel</p> <p>2 A. Had to do with an initial public</p> <p>3 offering.</p> <p>4 Q. And what was the nature of your</p> <p>5 expert testimony?</p> <p>6 A. That's going back. It's one of</p> <p>7 the most complicated cases I've been involved</p> <p>8 in. I recall that there was no due diligence</p> <p>9 done on the initial public offering price by</p> <p>10 the people who were supposed to certify it.</p> <p>11 And had they done a decent job,</p> <p>12 they would have come up with -- they wouldn't</p> <p>13 have left so much value on the table for the</p> <p>14 old shareholders. That's the gist of it.</p> <p>15 Q. Stephens v. American Equity</p> <p>16 Investment.</p> <p>17 A. Yes.</p> <p>18 Q. What was that case about, and</p> <p>19 which side did you testify for?</p> <p>20 A. I testified on the case of the</p> <p>21 defendant in that case. And the case boiled</p> <p>22 down to what was the point size of type in an</p> <p>23 insurance policy for surrender fees, and what</p> <p>24 is the front page. There was a law in</p> <p>25 California. Point size had to be a particular</p>	<p style="text-align: right;">Page 60</p> <p>1 D. Babbel</p> <p>2 other matters other than this matter?</p> <p>3 A. No.</p> <p>4 Q. Are you retained by Jones Day in</p> <p>5 any other matters other than this matter?</p> <p>6 A. No.</p> <p>7 Q. Have you ever conducted -- going</p> <p>8 back through your entire history of expert</p> <p>9 witnesses, have you ever conducted a lost</p> <p>10 profits calculation?</p> <p>11 MR. TAMBE: Objection to the form</p> <p>12 of the question.</p> <p>13 A. I'm almost sure I have. But as I</p> <p>14 sit here, I can't point to a case unless I</p> <p>15 look through all the cases. You gave me the</p> <p>16 last four years or five years' worth. But I'm</p> <p>17 sure I have.</p> <p>18 Q. Do you recall how you conducted</p> <p>19 the lost profits analysis?</p> <p>20 A. No. I imagine -- I know I've</p> <p>21 looked at lost profit calculations. I may</p> <p>22 have done some, but I don't recall.</p> <p>23 Q. How would you go about conducting</p> <p>24 a lost profit analysis?</p> <p>25 MR. TAMBE: Objection to the form</p>
<p style="text-align: right;">Page 59</p> <p>1 D. Babbel</p> <p>2 size, bold, and on the front page.</p> <p>3 And there were three definitions</p> <p>4 of front page. There's boilerplate pages, and</p> <p>5 there's the terms page, which insurers call</p> <p>6 front page. Then they put it on that page.</p> <p>7 But the plaintiffs acknowledge it</p> <p>8 should have been on the boilerplate page, and</p> <p>9 they stated: "Surrender fees 55 times the</p> <p>10 document."</p> <p>11 The plaintiff said, "Well, I</p> <p>12 never opened the document."</p> <p>13 So, anyway, she's a Berkley</p> <p>14 engineer.</p> <p>15 Q. James Jeffrey v. London Life</p> <p>16 Insurance Company. What side did you testify</p> <p>17 on behalf of?</p> <p>18 A. London Life Insurance.</p> <p>19 Q. What was the nature of that</p> <p>20 dispute?</p> <p>21 A. It was a merger between two</p> <p>22 companies and had to do with the rates of</p> <p>23 return that were provided on their insurance</p> <p>24 policies before and after the merger.</p> <p>25 Q. Are you retained by Lehman in any</p>	<p style="text-align: right;">Page 61</p> <p>1 D. Babbel</p> <p>2 of the question.</p> <p>3 A. It would depend so much on</p> <p>4 circumstances particular, you know, to the</p> <p>5 case. So I don't have, like, a general way of</p> <p>6 doing it.</p> <p>7 Q. Do you recall whether or not you</p> <p>8 engaged in such analysis with respect to a</p> <p>9 contract that was breached?</p> <p>10 A. I don't recall.</p> <p>11 Q. You indicate in your report that</p> <p>12 you assisted leading firms in the development</p> <p>13 of software for the valuation of assets and</p> <p>14 liabilities.</p> <p>15 Do you recall that?</p> <p>16 A. Yes.</p> <p>17 Q. Which firms have you assisted in</p> <p>18 the development of software for the valuation</p> <p>19 of assets and liabilities?</p> <p>20 A. Winklevoss, the father of the</p> <p>21 twins that are so famous, he has one of the</p> <p>22 biggest pension evaluation operations. I did</p> <p>23 for Goldman Sachs. Our method was used by</p> <p>24 Salomon Brothers for forward contracts in</p> <p>25 quantity adjusting options.</p>

<p style="text-align: right;">Page 62</p> <p>1 D. Babbel</p> <p>2 I did for Swiss Re, for their</p> <p>3 annuities -- that's where I actually did the</p> <p>4 software -- and many other companies, in terms</p> <p>5 of the approaches to take.</p> <p>6 Q. Have you ever consulted on the</p> <p>7 risks associated with entering into forward</p> <p>8 purchase agreements?</p> <p>9 MR. TAMBE: Object to the form of</p> <p>10 the question.</p> <p>11 You can answer.</p> <p>12 A. That were consulted on it?</p> <p>13 Q. Yes.</p> <p>14 A. No. I've taught on it. I don't</p> <p>15 remember consulting on it. I may have.</p> <p>16 Q. Tell me, in terms of that</p> <p>17 teaching that you just described, what do you</p> <p>18 teach about the risk of forward purchase</p> <p>19 agreements?</p> <p>20 A. Well, I took a two-week course in</p> <p>21 Bank of America on that when I was a professor</p> <p>22 at Berkley. And from even before that date, I</p> <p>23 was teaching how to price those sorts of</p> <p>24 contracts. That would be 1978-79.</p> <p>25 I took the course in about 1980.</p>	<p style="text-align: right;">Page 64</p> <p>1 D. Babbel</p> <p>2 A. Yes.</p> <p>3 Q. Is that a way -- is that an</p> <p>4 element that reflects the counterparty risk in</p> <p>5 a, for example, forward purchase agreement?</p> <p>6 MR. TAMBE: Object to form.</p> <p>7 Q. In terms of pricing?</p> <p>8 MR. TAMBE: Same objection.</p> <p>9 A. Counterparty risk is part of a</p> <p>10 forward agreement between two parties, and</p> <p>11 it's taken into account through negotiations.</p> <p>12 And it also depends on -- it can evolve over</p> <p>13 time. It depends on who's in the money and</p> <p>14 who's not.</p> <p>15 But a typical agreement at the</p> <p>16 beginning is done on a par basis. But there</p> <p>17 can be credit charges as part of that.</p> <p>18 Q. So if the dealer perceives that</p> <p>19 the counterparty has a greater potential for</p> <p>20 default, that would result in a larger credit</p> <p>21 charge. Is that fair?</p> <p>22 A. It could.</p> <p>23 Q. Have you ever hedged a forward</p> <p>24 purchase agreement?</p> <p>25 A. I guess I have.</p>
<p style="text-align: right;">Page 63</p> <p>1 D. Babbel</p> <p>2 And they were more complex forward purchase</p> <p>3 agreements than the current contract because</p> <p>4 they involved multiple countries and</p> <p>5 currencies. So I taught that for years.</p> <p>6 Q. You agree that there are risks</p> <p>7 involved in forward purchase agreements.</p> <p>8 Correct?</p> <p>9 A. Sure.</p> <p>10 Q. And is there, in terms of -- have</p> <p>11 you been involved in pricing for forward</p> <p>12 purchase agreements?</p> <p>13 MR. TAMBE: Object to the form.</p> <p>14 You can answer.</p> <p>15 Q. That is how a dealer should price</p> <p>16 a forward purchase agreement?</p> <p>17 A. I have in the case of the</p> <p>18 contracts I just mentioned, yes.</p> <p>19 Q. And what -- how do you account</p> <p>20 for risk in the pricing of a forward purchase</p> <p>21 agreement?</p> <p>22 A. Well, there's, counterparty</p> <p>23 risks. That's the major one.</p> <p>24 Q. Are you familiar with the term</p> <p>25 "credit charge"?</p>	<p style="text-align: right;">Page 65</p> <p>1 D. Babbel</p> <p>2 Q. Tell me about that.</p> <p>3 A. It's a homemade version. But I</p> <p>4 had a bonus that was an escalating bonus that</p> <p>5 went over five years. And because I had the</p> <p>6 chance of leaving the firm, I decided to hedge</p> <p>7 it all because I had to return part of it if I</p> <p>8 left.</p> <p>9 So I used forward rates and I</p> <p>10 used interest rate caps and I got caplets for</p> <p>11 each of the five payments. It was a</p> <p>12 substantial amount, and so I needed to do</p> <p>13 that. So I did. I hedged it.</p> <p>14 Q. And the purpose of hedging is to</p> <p>15 try to lock in the perceived rates that you</p> <p>16 were going to -- the return you were going to</p> <p>17 otherwise obtain from these five years of</p> <p>18 bonus payments. Is that right?</p> <p>19 MR. TAMBE: Objection to form.</p> <p>20 You can answer.</p> <p>21 A. The purpose was: If I walked</p> <p>22 away, I would have to come up with some amount</p> <p>23 to give the firm back and the interest rates</p> <p>24 could change during the interim. So I hedged</p> <p>25 it.</p>

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1 D. Babbel
2 Q. Hedging is to protect against
3 interest rate fluctuation. Is that fair?
4 A. That's right.
5 Q. But in terms of your work for
6 financial institutions, you've never hedged a
7 deal for Goldman or any other dealer. Is that
8 right?
9 A. I've told them how to hedge it.
10 I didn't do the transaction. I helped a lot
11 of institutions on that.
12 Q. So they will present you with an
13 instrument, and you will give advice as to how
14 to hedge the risks associated with that
15 instrument?
16 A. Or a portfolio, yes.
17 Q. And with respect to those
18 instruments, the purpose of the hedge -- like
19 for your personal hedge -- was to try to
20 address the interest rate risks associated
21 with entering into a transaction. Is that
22 fair? Or a portfolio of transactions?
23 A. Yes.
24 Q. Did -- has any of your work
25 involved analyzing transactions with -- or

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1 D. Babbel
2 potential transactions with municipal
3 government entities?
4 A. I've had to calculate the ratios
5 that companies would need to use to hedge
6 municipal debt.
7 Q. Explain that.
8 A. Well, I'm an asset liability
9 management specialist. And so when a
10 financial institution has, among in their
11 assets, municipal debt, it has particular
12 sensitivities in their value to movements in
13 their interest rates.
14 And I had to look at that and
15 estimate its sensitivity and what kind of
16 liabilities -- if they had those kind of
17 assets, what kind of liabilities would be
18 appropriate and how they should price those.
19 Q. How does the fact that you're
20 dealing with a municipal entity change or
21 alter the thinking than if you're dealing with
22 a corporate entity that you were doing the
23 transaction with?
24 MR. TAMBE: Objection to form.
25 A. I wasn't dealing with a municipal

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1 D. Babbel
2 entity. I was dealing with regular
3 corporations who happen to own municipal debt.
4 Q. Right. I'm talking about on the
5 other side of the deal. In other words, you
6 have advised people who have, as you said,
7 considered assets that are municipal debt and
8 considered assets also that are corporate
9 debt, I assume. Correct?
10 A. Yes.
11 Q. How is the fact that you're
12 dealing with municipal debt as opposed to
13 corporate debt matter? Or does it matter?
14 A. It's sensitive in its price
15 movement, the value of the municipal bonds, to
16 interest rates that take into account a tax
17 treatment factor.
18 Q. Other than that, any differences?
19 A. Well, there's a lot of kinds of
20 municipal debt, if it's a full faith and
21 credit or if it's a revenue bond. They even
22 have financial -- very short-term financial
23 payment.
24 Q. And revenue bonds are considered
25 more riskier than full faith bonds. Correct?

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1 D. Babbel
2 MR. TAMBE: Objection to the
3 form.
4 A. It depends on the source of
5 revenue and the municipality standing behind
6 it. They could be safer.
7 Q. With putting aside the exception,
8 such as Detroit, if you have a relatively
9 healthy municipality, would you say that full
10 faith in credit bonds tend to be safer than
11 revenue-backed bonds?
12 MR. TAMBE: Same objection.
13 A. You have to be more specific than
14 that question. Name the municipality and name
15 the source of revenue. If it's a Bridge at
16 Turnpike revenue, pretty solid, versus, not
17 just Detroit but eventually California cities.
18 And the municipalities have
19 credit rating all over the map, but the
20 revenue bonds are dependent upon the source of
21 revenue.
22 Q. So with assessing that type of
23 thing, you really want to know very much the
24 specifics of the investment instrument that
25 you're considering. Correct?

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<p>1 D. Babbel</p> <p>2 A. If I'm investing in a security,</p> <p>3 I'd like to know the risk behind it.</p> <p>4 Q. Or if you're advising someone</p> <p>5 about an investment securement, you want to</p> <p>6 know the specific risks involved in that</p> <p>7 instrument. Correct?</p> <p>8 A. Yes.</p> <p>9 Q. In this case, does your opinion</p> <p>10 depend upon the specific risk associated with</p> <p>11 the RFA, Reserve Fund Agreement, at issue?</p> <p>12 A. My specific opinion is that</p> <p>13 forward rates are used in valuation of swaps,</p> <p>14 and that doesn't change.</p> <p>15 Q. I understand that. But have you</p> <p>16 looked at -- have you read the Reserve Fund</p> <p>17 Agreement in this case?</p> <p>18 A. I did.</p> <p>19 Q. Does your opinion depend at all</p> <p>20 on the specific details of that instrument?</p> <p>21 MR. TAMBE: Objection to the</p> <p>22 form.</p> <p>23 You can answer.</p> <p>24 A. That instrument is gone.</p> <p>25 Q. Right.</p>	<p>1 D. Babbel</p> <p>2 MR. TAMBE: Objection to the form</p> <p>3 of the question.</p> <p>4 A. People use tools to evaluate</p> <p>5 whether they are good deals or not. There</p> <p>6 are -- the better tool you have, the better</p> <p>7 assessment you can make.</p> <p>8 Q. And I assume you're in favor of</p> <p>9 model-based tools as opposed to intuition?</p> <p>10 A. That's my training.</p> <p>11 Q. That's what you research and</p> <p>12 write about?</p> <p>13 A. That's right.</p> <p>14 Q. You would agree that the events</p> <p>15 in fall 2008, that are sometimes known as the</p> <p>16 "Great Recession" -- have you heard that</p> <p>17 terminology before, the "Great Recession"?</p> <p>18 A. I have.</p> <p>19 Q. Do you agree the Great Recession</p> <p>20 has caused substantial disruption in the</p> <p>21 markets?</p> <p>22 A. I do.</p> <p>23 Q. How so?</p> <p>24 A. The liquidity in some markets was</p> <p>25 quite limited. Pricing was more difficult to</p>
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<p>1 D. Babbel</p> <p>2 A. It's ineffective. So you're just</p> <p>3 looking at what the residual cash flows would</p> <p>4 have been, one way or the other, and evaluate</p> <p>5 that. But the rest of the instrument is gone.</p> <p>6 Q. In your experience, is there any</p> <p>7 difference in the way that academics or</p> <p>8 researchers, such as you, would approach</p> <p>9 values as opposed to a trader on the floor?</p> <p>10 MR. TAMBE: Objection to the form</p> <p>11 of the question.</p> <p>12 A. It depends, truly, on the trader.</p> <p>13 Some traders use rules of thumb. Some use</p> <p>14 very technical models.</p> <p>15 And so I've worked with the</p> <p>16 people that were in charge of investing</p> <p>17 Goldman Sachs' own capital. They use the most</p> <p>18 sophisticated models in the world. Whether</p> <p>19 all the traders understand and are beholden to</p> <p>20 those models, I don't know. But I don't think</p> <p>21 so.</p> <p>22 Q. What is a consequence of the fact</p> <p>23 that certain people are trading based on</p> <p>24 models versus rules of thumb or other</p> <p>25 nonmodel-based perspectives in the market?</p>	<p>1 D. Babbel</p> <p>2 do in those sorts of markets.</p> <p>3 Q. Why was pricing more difficult to</p> <p>4 do?</p> <p>5 A. Sometimes you would have to go to</p> <p>6 models if you couldn't find live transactions.</p> <p>7 Q. What -- and maybe I'm wrong. But</p> <p>8 I assume that models tend to use live</p> <p>9 transaction data as the data points that are</p> <p>10 input into the model. Correct?</p> <p>11 A. That's correct.</p> <p>12 Q. So explain to me the distinction</p> <p>13 you were making between going to models rather</p> <p>14 than using live transactions?</p> <p>15 A. Yes.</p> <p>16 MR. TAMBE: Objection to the form</p> <p>17 of the question.</p> <p>18 You can answer.</p> <p>19 A. I just said, "Models are based on</p> <p>20 live transactions." Those are the inputs for</p> <p>21 the models. The models are ways for</p> <p>22 interpolating between dates and across</p> <p>23 instruments.</p> <p>24 There's a lot of information.</p> <p>25 There was always a lot of information in the</p>

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<p>1 D. Babbel</p> <p>2 market for pricing securities. That doesn't</p> <p>3 mean every single security would attract</p> <p>4 traders at any given moment.</p> <p>5 But that doesn't -- it also</p> <p>6 doesn't mean that you can't put a value on</p> <p>7 that instrument based upon value of cash flows</p> <p>8 and the timing of cash flows, which we can do</p> <p>9 through the term structure of interest rates.</p> <p>10 Q. I want to try to make sure I</p> <p>11 understand the distinction you're drawing.</p> <p>12 You can certainly look at an instrument and</p> <p>13 look at its anticipated cash flows. Correct?</p> <p>14 MR. TAMBE: Objection to the</p> <p>15 form.</p> <p>16 You can answer.</p> <p>17 A. You can look at an instrument if</p> <p>18 it has promised cash flows. You can model</p> <p>19 that.</p> <p>20 Q. When you say "model that," you</p> <p>21 don't really need to model it because you</p> <p>22 have -- if you have a guaranteed cash flow,</p> <p>23 you have a guaranteed cash flow. It's just</p> <p>24 inputting those guaranteed flows into a model.</p> <p>25 Correct?</p>	<p>1 D. Babbel</p> <p>2 actual transaction on a particular day because</p> <p>3 that tells you what market -- what is</p> <p>4 happening in the market in real time.</p> <p>5 Correct?</p> <p>6 MR. TAMBE: Objection to form.</p> <p>7 A. You're mixing a little bit of the</p> <p>8 time. If you look on a particular day, that</p> <p>9 doesn't tell you what something's worth. That</p> <p>10 tells you what something was worth at the</p> <p>11 moment that it traded. Right?</p> <p>12 So you have some data that is</p> <p>13 relevant for what happened in the past. But</p> <p>14 if you have quotes available for the current</p> <p>15 time, that's different than whatever the past</p> <p>16 data happened to say, typically, if the price</p> <p>17 is -- the prices are moving all the time.</p> <p>18 Q. What I'm trying to understand is</p> <p>19 the distinction you're making between the</p> <p>20 situation where you don't have live</p> <p>21 transactions, when you have to resort to</p> <p>22 modeling. Can you give me an example?</p> <p>23 A. When you say "live</p> <p>24 transactions" --</p> <p>25 Q. I think that was your</p>
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<p>1 D. Babbel</p> <p>2 A. That's what I thought I said.</p> <p>3 That's what I mean by "model." You put them</p> <p>4 into a formula and then you discount them and</p> <p>5 you add their values.</p> <p>6 Q. So in terms of what I think you</p> <p>7 were saying before and distinguishing between</p> <p>8 talking about -- sorry -- the impacts of the</p> <p>9 great recession on the market, you indicated</p> <p>10 that there are certain instruments that</p> <p>11 because of lack of live transactional data,</p> <p>12 you would have to go to models. I'm still</p> <p>13 trying to understand that.</p> <p>14 When you have a floating rate</p> <p>15 instrument without sufficient market</p> <p>16 transactions to give you valid data points,</p> <p>17 how do you use a model to come up with an</p> <p>18 alternative?</p> <p>19 A. I don't know of any period during</p> <p>20 the great recession when we didn't have</p> <p>21 sufficient data to model something with</p> <p>22 floating interest rates. We did.</p> <p>23 Q. So do I -- just -- just so I</p> <p>24 understand what you were saying before is:</p> <p>25 The preference always is to go and look at the</p>	<p>1 D. Babbel</p> <p>2 terminology.</p> <p>3 A. Okay. But live transactions,</p> <p>4 there's two ways to think of it. A</p> <p>5 transaction that was live and just happened or</p> <p>6 a transaction that's available to happen now.</p> <p>7 Which do you mean?</p> <p>8 Q. You used the terminology. So you</p> <p>9 tell me what you meant when you used the</p> <p>10 terminology.</p> <p>11 A. Well, if you have transactions,</p> <p>12 bids and asks prices for instruments available</p> <p>13 now, that's more important than if you had</p> <p>14 something two minutes ago, stale data.</p> <p>15 That doesn't mean that the stale</p> <p>16 data won't give you at least an indication of</p> <p>17 what it might be worth, depending on what's</p> <p>18 happened in the interim. There's some events</p> <p>19 that can happen in a very short period of time</p> <p>20 that change the value substantially.</p> <p>21 Q. When a person generates a forward</p> <p>22 curve, should they be looking at the bid and</p> <p>23 ask numbers at a given point or should they be</p> <p>24 looking at actual completed transaction at a</p> <p>25 given point or some combination thereof?</p>

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1 D. Babbel
2 MR. TAMBE: Objection to the form
3 of the question.
4 A. Who's looking?
5 Q. Who's looking? Say, a dealer
6 trying to price an instrument.
7 A. So the dealers will look at the
8 ask side. They also look at the bid side too.
9 A lot of markets are very tight where the
10 difference is minuscule.
11 Sometimes you'll get a quote
12 where there's no difference. But yeah, they
13 should look at the forward rates and spot
14 rates if those are relevant to whatever
15 instruments that they're concerned with.
16 Q. If you're doing an interest rate
17 curve, a forward curve on interest rates for,
18 say, T-Bills. Walk through how you generate
19 your forward curve. What data points do you
20 input?
21 A. On T-Bills -- you have T-Bills of
22 various maturities going out through 360 days.
23 It's not a very interesting curve but --
24 Q. Let's take in a security that can
25 go out -- you can buy for one year -- three

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1 D. Babbel
2 months up to thirty years.
3 A. What data do you take?
4 Q. Yeah.
5 A. You take -- you have the bond
6 prices. Associated with the bond prices, is a
7 yield. It can be calculated. Sometimes the
8 bonds are even quoted in terms of yield as
9 opposed to price. They're two sides of the
10 same coin.
11 Those yields are particular to an
12 instrument. And what you need to do, if
13 you're going to price anything other than that
14 instrument, you have to calculate spot rates
15 and forward rates.
16 Now, the reason I say that is
17 because the yield is particular to that
18 instrument and no other instrument on Earth.
19 It reflects the particular cash flows and the
20 timing of the cash flows and the size of the
21 cash flows of that instrument.
22 Now, closely related to other
23 instruments, the timing of the cash flows
24 might be slightly different, but it's
25 credit-worthiness backing are the same.

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1 D. Babbel
2 But the yield that you get from
3 that particular instrument, treasury bond, is
4 particular only to that treasury bond. So you
5 have to extract from that yield to maturity
6 something that's useful, which is a spot rate.
7 And the yield to maturity on a
8 treasury bond is that -- you're not going to
9 like this -- a dollar duration weighted
10 average of the underlying spot rates or
11 forward rates. And the dollar duration
12 ratings depend upon that particular
13 instrument, which is unique to that
14 instrument, and they don't apply to any other
15 instrument.
16 That's why you can't use yields
17 to maturity on a bond to price to another
18 bond, not if you're vigorous. You decompose
19 it to the underlying spot rates which you can
20 use for any other instrument and their
21 associated forward rates, which again are two
22 sides of a different coin.
23 Q. So you have a bond, and you see
24 what the prices are for someone purchasing the
25 bond of -- the maturities out on different

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1 D. Babbel
2 bonds for three months, six months, five
3 years, ten years, twenty years. Correct?
4 A. Yes.
5 Q. And you can look at transactions
6 and figure out what the yield was for a
7 particular transaction. Correct?
8 A. Yes.
9 Q. Okay. And then you're trying to
10 extrapolate out information from those sets of
11 transactions to yield the spot rates.
12 Correct?
13 A. Yes.
14 Q. And -- again, because I don't
15 want to make an assumption -- do you use those
16 transactions to generate a spot rate?
17 A. There's something called
18 "bootstrapping," which is the oldest and most
19 common method, where you're able to determine
20 what spot rates were associated with that bond
21 to create the particular yield to maturity.
22 And it's an iterative process.
23 You start with one bond, like the treasury
24 bill. The spot rate and the yield are one in
25 the same, if the yield is calculated

<p style="text-align: right;">Page 82</p> <p>1 D. Babbel</p> <p>2 appropriately.</p> <p>3 It's not a discount -- it's</p> <p>4 usually reported on a discount basis, but you</p> <p>5 can turn that into a yield maturity. It's one</p> <p>6 in the same thing. You can take that treasury</p> <p>7 bill and go out and mature. Now, you have a</p> <p>8 bond with coupons.</p> <p>9 So its yield isn't helpful, but</p> <p>10 its price is. You know what the price of the</p> <p>11 whole bond is. You know what the market is</p> <p>12 telling you the first years' worth is because</p> <p>13 we have certainty on that.</p> <p>14 So it just takes algebra to</p> <p>15 figure out the forward rate, and also the spot</p> <p>16 rate, for two years. Once you've figured out</p> <p>17 that, you can continue on out three, four,</p> <p>18 five --</p> <p>19 You don't even really need to do</p> <p>20 that now in zero-coupon bonds because it tells</p> <p>21 you all the way out to thirty years what</p> <p>22 everything is worth on a quarterly basis.</p> <p>23 Q. So how do you use that</p> <p>24 information -- let's say you want to assess an</p> <p>25 agency security in the yield --</p>	<p style="text-align: right;">Page 84</p> <p>1 D. Babbel</p> <p>2 Q. You gave the example in your</p> <p>3 report of the runner with the hundred-yard</p> <p>4 dash.</p> <p>5 A. Yes.</p> <p>6 Q. And I assume the point there was</p> <p>7 that if you know the time or the yield at the</p> <p>8 end of the hundred yards and you know the time</p> <p>9 or the yield at the end of fifty yards, you</p> <p>10 can extrapolate and figure out the yield or</p> <p>11 time for the final fifty yards. Correct?</p> <p>12 A. That was the idea.</p> <p>13 Q. The same way with respect to a</p> <p>14 security or an instrument. If you know what</p> <p>15 the yield is through nine years, you know what</p> <p>16 the yield is through ten years, you can</p> <p>17 extrapolate what the one-year yield would be</p> <p>18 if you purchased a year nine. Correct?</p> <p>19 A. You can. But it's a little more</p> <p>20 complicated because unless it's a zero-coupon</p> <p>21 bond, it would be akin to the runner getting</p> <p>22 to the 50-yard line and throwing off his water</p> <p>23 bottle and then running the rest of it, and</p> <p>24 throwing off coupons.</p> <p>25 And so it takes someone with a</p>
<p style="text-align: right;">Page 83</p> <p>1 D. Babbel</p> <p>2 A. Yes.</p> <p>3 Q. -- how would you go about using</p> <p>4 the information? Do you use the information</p> <p>5 from the treasuries for the agency securities</p> <p>6 analysis?</p> <p>7 A. You could, but then you'd have to</p> <p>8 add a spread, because it's not the same</p> <p>9 market. That spread would be a positive</p> <p>10 spread.</p> <p>11 But the agency market is really</p> <p>12 quite rich in data. So you can also use a</p> <p>13 bootstrapping method, but you're going to have</p> <p>14 some voids because it's not as deep as the</p> <p>15 treasury market. You have to interpolate.</p> <p>16 Q. And how do you interpolate those</p> <p>17 missing data points in the agency market?</p> <p>18 A. Well, the Treasury produces a</p> <p>19 formula for doing that, and it's very useful</p> <p>20 for the agency market as well. It shows you</p> <p>21 exactly how they interpolate and they publish</p> <p>22 these things every day.</p> <p>23 The market is actually interested</p> <p>24 in these things every minute. So there are</p> <p>25 other programs that will do that.</p>	<p style="text-align: right;">Page 85</p> <p>1 D. Babbel</p> <p>2 little bit of skill to do this. And there are</p> <p>3 readily available programs now to do it.</p> <p>4 Q. How do you account for the</p> <p>5 difficulty you described, sticking with the</p> <p>6 agency securities? You have market</p> <p>7 information for nine, you have market</p> <p>8 information for ten.</p> <p>9 You're trying to figure out what</p> <p>10 someone nine years from now could yield on a</p> <p>11 one-year treasury -- I'm sorry -- one-year</p> <p>12 agency. How do you go about making that? You</p> <p>13 said there's some complication to it, and you</p> <p>14 would have to make adjustments?</p> <p>15 A. Because the cash flows aren't one</p> <p>16 time per year. They are typically semi-annual</p> <p>17 cash flows. Some you can even have quarterly.</p> <p>18 Q. Right.</p> <p>19 A. But most bonds are semi-annual.</p> <p>20 So if you're trying to get between year, say,</p> <p>21 nine and ten, and you have instruments on both</p> <p>22 dates, but you don't have one on nine and a</p> <p>23 half years, you have to make an interpolation</p> <p>24 for a nine-and-a-half year rate.</p> <p>25 Q. How do you do that?</p>

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1 D. Babbel
2 A. Well, the published programs are
3 quite available, and they typically follow a
4 curve that best explains all of the data
5 points where you have current quotations.
6 Q. And is it always a curve rather
7 than straight line between two data points?
8 A. To the -- to the eye, some of it
9 might look like a straight line when you get
10 out far enough.
11 Q. But, technically, there's always
12 some curvature in there?
13 A. Technically, yes.
14 Q. So the forward curve depends on
15 market data. Correct?
16 A. Yes.
17 Q. And it gives you -- it gives you
18 information based on market expectations of
19 future interest rates. Correct?
20 A. There are theories. If you take
21 a couple of steps and are willing to make a
22 bunch of assumptions, you could -- you could
23 try to say that, yes.
24 Q. You could, as opposed to what?
25 A. Well, the forward curve tells you

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1 D. Babbel
2 what the price of making a commitment is in
3 the future. It tells you what rate you need
4 to be able to transact at. And then that can
5 be adjusted for other costs and things like
6 that.
7 Q. You would agree, though, that the
8 forward curve is, more often than not, wrong
9 in the sense that it will tell you on day one
10 what the predicted yield will be on year
11 eight. But if you went out to year eight, the
12 chances of it actually being that point on a
13 forward curve would be pretty small?
14 MR. TAMBE: Objection to the form
15 of the question.
16 You can answer.
17 A. The forward curve doesn't tell
18 you the predicted value. Like I said, you
19 need to take a couple of assumptions if you
20 want to do that. And depending on the
21 assumptions, it would come up with different
22 predicted values.
23 But the forward rate, that's not
24 what it's all about. It's telling you today's
25 cost for making a forward commitment either

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1 D. Babbel
2 buying or selling, and it doesn't really have
3 -- there's no necessary link between that and
4 predictions.
5 Q. So it's not a predictive tool?
6 A. People sometimes use it as a
7 predictive tool if they have various theories
8 that they want to try to predict things.
9 I mean, people are always trying
10 to predict things in the market. They're
11 looking for an edge. Forward rates, I've seen
12 it used before as a predictive tool.
13 Q. Do you think it's an appropriate
14 predictive tool to predict what, in fact,
15 interest rates will be five years out?
16 A. Is it an appropriate tool? It
17 embeds all the information we currently have
18 about the future. So if you have more
19 information somehow that the market doesn't,
20 you wouldn't want to use a forward rate.
21 If you did use a forward rate,
22 the question is: Is it a predictor of the
23 future short rate? Not necessarily.
24 You have to invoke a whole
25 architecture of theory. One has to do with

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1 D. Babbel
2 the risk aversion. One has to do with risk
3 preference, liquidity preference -- there are
4 all sorts of things that people of -- they're
5 trying to use forward rates to help them
6 predict the future, maybe, and they're seeing
7 if they can. But that's not what the forward
8 rates about. The forward rates is independent
9 of that.
10 Q. Would you agree that if you took
11 a forward rate on a given day, looked at what
12 it predicted out for short-term rates over
13 time, keep looking at the forward curve
14 generated day-to-day, that the forward curve
15 would mispredict short-term rates in over 90
16 percent of the cases?
17 MR. TAMBE: Objection to the form
18 of the question.
19 Q. I won't use the word "predict."
20 The forward curve -- look at the each day,
21 what the forward curve is. Look at then what
22 actual short-term rates turn out to be. Would
23 you agree that the forward curve generates a
24 short-term rate that is not accurate more than
25 90 percent of the time?

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<p>1 D. Babbel</p> <p>2 MR. TAMBE: Same objection.</p> <p>3 A. I think I understand the</p> <p>4 question.</p> <p>5 Let me ask what you mean by</p> <p>6 "accurate."</p> <p>7 Q. Meaning, you look at the forward</p> <p>8 curve generated on a particular day, say March</p> <p>9 25, 2009, and you use that forward curve to</p> <p>10 give you information about what a six-month</p> <p>11 agency yield might be eight years from now.</p> <p>12 Correct?</p> <p>13 A. Correct.</p> <p>14 Q. And then you now go out eight</p> <p>15 years, and you look at what is the actual</p> <p>16 six-month yield on that same agency security,</p> <p>17 eight years out.</p> <p>18 So I'm comparing those two</p> <p>19 numbers: the actual eight years out, and the</p> <p>20 number generated by the forward curve eight</p> <p>21 years earlier. Those numbers would be</p> <p>22 different at least 90 percent of the time. Is</p> <p>23 that fair?</p> <p>24 MR. TAMBE: Objection to the form</p> <p>25 of the question.</p>	<p>1 D. Babbel</p> <p>2 Q. That wasn't my question. My</p> <p>3 question is simply: Whether or not you would</p> <p>4 agree that the forward rate predicted on a</p> <p>5 given day for eight years out is more likely</p> <p>6 than not going to be different than the actual</p> <p>7 rate on that given day eight years out.</p> <p>8 MR. TAMBE: Objection to the</p> <p>9 form.</p> <p>10 A. Well, now you said the forward</p> <p>11 rate predicted.</p> <p>12 Q. I know you don't like to do the</p> <p>13 prediction work.</p> <p>14 A. It doesn't predict.</p> <p>15 Q. The forward curve gives you a</p> <p>16 number?</p> <p>17 A. It gives you a number, today's</p> <p>18 price of making a future commitment.</p> <p>19 Q. Right. And you go out eight</p> <p>20 years, and you look to see whether or not the</p> <p>21 six-month yield is at the number the forward</p> <p>22 curve generated.</p> <p>23 Would you agree it's more likely</p> <p>24 than not that the eight-year-out number is</p> <p>25 going to be different than the number that was</p>
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<p>1 D. Babbel</p> <p>2 A. My question to you is: What do</p> <p>3 you mean by "accurate" or "different"? If one</p> <p>4 says 6.23 percent and the other says 6.24,</p> <p>5 would that be a failure of prediction?</p> <p>6 Q. Let's start with that. Would you</p> <p>7 agree that -- in terms of exact numbers --</p> <p>8 that it would be different more than 90</p> <p>9 percent of the time?</p> <p>10 A. I don't know. If it's more than</p> <p>11 90 percent --</p> <p>12 Q. If you haven't done that work,</p> <p>13 you can just say, "I don't know."</p> <p>14 A. That's not how economists look at</p> <p>15 things. Maybe that's what they do in Las</p> <p>16 Vegas, point spreads, and things like that.</p> <p>17 We look at market data as a rich source of</p> <p>18 information for market consensus of all these</p> <p>19 players in the market, and we try to extract</p> <p>20 information from that.</p> <p>21 But I've never heard 90 percent</p> <p>22 of the time these -- the forward rates get</p> <p>23 the -- are -- are a deviance with the actual</p> <p>24 future rate that ensues. That doesn't mean</p> <p>25 forward rates aren't useful.</p>	<p>1 D. Babbel</p> <p>2 generated by the forward curve?</p> <p>3 A. You're creating a link where</p> <p>4 there's no necessary link. Eight years from</p> <p>5 now there's different information, different</p> <p>6 prices.</p> <p>7 The forward rate tells you</p> <p>8 today's price of making a future commitment.</p> <p>9 It doesn't tell you the future price of making</p> <p>10 that commitment. You have to add a whole</p> <p>11 bunch of assumptions to get to that point.</p> <p>12 Q. Now, the typical oversimplified</p> <p>13 version of modeling is, sort of, the</p> <p>14 garbage-in-garbage-out equation, which means</p> <p>15 that the quality of the data input is</p> <p>16 important to understanding the quality of the</p> <p>17 model. Correct?</p> <p>18 A. Yes.</p> <p>19 Q. And the forward curve model</p> <p>20 depends on market data. Correct? The data</p> <p>21 inputs are market information?</p> <p>22 A. The forward curve does not depend</p> <p>23 upon market data. The calibration of the</p> <p>24 forward curve depends upon market data.</p> <p>25 Q. The inputs into the -- the data</p>

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<p>1 D. Babbel</p> <p>2 inputs into the forward curve is market data.</p> <p>3 Correct?</p> <p>4 A. Yes.</p> <p>5 Q. You could input data of the</p> <p>6 opinions of a thousand economists and use that</p> <p>7 instead. Correct?</p> <p>8 A. You could.</p> <p>9 Q. You could take a thousand people</p> <p>10 on the street and ask them their view of</p> <p>11 yields, eight years out, and do a forward</p> <p>12 curve based on the thousand people on the</p> <p>13 street. Correct?</p> <p>14 A. You could.</p> <p>15 Q. And the usefulness of the forward</p> <p>16 curve depends upon its usefulness in the</p> <p>17 market. Correct?</p> <p>18 MR. TAMBE: Objection to the form</p> <p>19 of the question.</p> <p>20 A. It has lots of uses. The market</p> <p>21 is one of them.</p> <p>22 THE WITNESS: Could you read back</p> <p>23 two questions ago where Mr. Lawrence was</p> <p>24 talking about going to a thousand</p> <p>25 economists -- which is near and dear to</p>	<p>1 D. Babbel</p> <p>2 (Record read.)</p> <p>3 THE WITNESS: That's enough. No.</p> <p>4 So we don't need the rest of the</p> <p>5 question.</p> <p>6 Q. I'm sorry. So what's wrong with</p> <p>7 that statement? You said you disagreed with</p> <p>8 it.</p> <p>9 A. That you use all these rates</p> <p>10 about what future interest rates will be, and</p> <p>11 that could be used to generate a forward</p> <p>12 curve. That implies a prediction of that</p> <p>13 future rate --</p> <p>14 Q. Or -- I'm sorry.</p> <p>15 A. -- as generated based upon</p> <p>16 current data. You just need a calculator.</p> <p>17 You don't need expectations in there.</p> <p>18 A thousand economists or one</p> <p>19 economists, I can do it without any</p> <p>20 expectations. Just give me a calculator.</p> <p>21 Q. I understand. The word,</p> <p>22 "expectations" may be the wrong word. In</p> <p>23 market data, you're doing data on what people</p> <p>24 are paying for particular instruments that</p> <p>25 have, you know, dates five, ten, fifteen years</p>
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<p>1 D. Babbel</p> <p>2 my heart because I see an employment</p> <p>3 opportunity here -- and asking them what</p> <p>4 the forward curve is or something like</p> <p>5 that?</p> <p>6 Q. I meant -- what I said was: You</p> <p>7 get data from the market about what yields</p> <p>8 will be at a particular point out into the</p> <p>9 future. And that is data that then is used to</p> <p>10 generate a forward curve. Right?</p> <p>11 And you could also go to a</p> <p>12 thousand economists and say, "What do you</p> <p>13 expect the yields to be -- a year, two years,</p> <p>14 three years, five years, ten years, twenty</p> <p>15 years out?"</p> <p>16 And you put that as data points</p> <p>17 and generate a forward curve. Correct? You</p> <p>18 may call it something else, but you're</p> <p>19 generating a curve that reflects the</p> <p>20 economists' predictions?</p> <p>21 A. Well, could you read that entire</p> <p>22 statement back? Because the first part of it</p> <p>23 is a question -- had an assumption there that</p> <p>24 I didn't buy. But go ahead and read it.</p> <p>25 MR. LAWRENCE: Okay.</p>	<p>1 D. Babbel</p> <p>2 out. Correct?</p> <p>3 A. Correct.</p> <p>4 Q. With economists, I think you</p> <p>5 would be asking them to do their best</p> <p>6 prediction on what rates would be on agency</p> <p>7 securities five, ten, fifteen years out. But</p> <p>8 you could generate a forward curve based on</p> <p>9 economists' predictions. Correct?</p> <p>10 A. That's not a forward curve. A</p> <p>11 forward curve has to do only with current</p> <p>12 prices.</p> <p>13 Q. So you would generate -- you</p> <p>14 would generate a curve and call it something</p> <p>15 else?</p> <p>16 A. Call it "predictions," yeah.</p> <p>17 Q. Because, certainly, the forward</p> <p>18 curve is not about predictions.</p> <p>19 A. No. It is to some people. But</p> <p>20 that's not how it's constructed.</p> <p>21 Q. That's now how it's supposed to</p> <p>22 be used in your view as an economist and in</p> <p>23 your view, based on your opinion, in this</p> <p>24 case?</p> <p>25 A. I won't say that's not how it's</p>

<p style="text-align: right;">Page 98</p> <p>1 D. Babbel 2 supposed to be used. People can use the 3 curve. And if they can get some information 4 on or about the future, bless their hearts. 5 But it's calculated based upon the present. 6 Q. You're not opining that it's a 7 good predictive tool. Correct? 8 A. I'm not saying one way or the 9 other. There's a big debate about that. 10 MR. LAWRENCE: Why don't we take 11 a lunch break. 12 (Lunch recess taken from 13 12:34 p.m. to 1:41 p.m.) 14 15 16 17 18 19 20 21 22 23 24 25</p>	<p style="text-align: right;">Page 100</p> <p>1 D. Babbel 2 A. Well, they cite me, so they must 3 be right. 4 Q. There you go. 5 A. They have a specialty in that 6 area. They're cited a lot. 7 Q. They're cited a lot in that 8 field, in the area in which they write? 9 A. They have interest rate models. 10 That's a two-factor model that then became a 11 famous model for stochastic processes of 12 interest rates. 13 Q. And their work is cited within 14 your field of expertise? 15 A. Yes. I know a lot about that 16 field. 17 Q. If you'll turn to page 2 of your 18 report under "Assignment." 19 A. Yes. 20 Q. You were asked to review the 21 Curry and Hasterok valuation report. Is that 22 correct? 23 A. That is correct. 24 Q. And as I understand it, you have 25 not calculated an alternative number that</p>
<p style="text-align: right;">Page 99</p> <p>1 D. Babbel 2 A F T E R N O O N S E S S I O N 3 (Time noted: 1:41 p.m.) 4 D A V I D F. B A B B E L, resumed and 5 testified as follows: 6 CONTINUED EXAMINATION 7 BY MR. LAWRENCE: 8 Q. If you could turn to page 2 of 9 your report. 10 A. Sure. 11 Q. Before we get there, have you 12 ever heard of a piece called "Valuing 13 Derivatives: Funding Value Adjustments and 14 Fair Value" by Hall and White, John Hall and 15 Alan White? 16 A. I don't recall the title of it, 17 but I've read books of theirs and I've read 18 papers of theirs. 19 Q. What is the estimation of 20 Mr. Hall and Mr. White within your area of 21 expertise, financial market -- finances? 22 MR. TAMBE: Objection to the form 23 of the question. 24 Q. Are they considered reliable 25 persons?</p>	<p style="text-align: right;">Page 101</p> <p>1 D. Babbel 2 would put TSA back in the same position it 3 would have enjoyed had the RFA not been 4 terminated. Is that right? 5 A. That's right. 6 Q. Nor have you opined as to the 7 appropriate methodology to come up with that 8 number. Correct? 9 MR. TAMBE: Objection to the form 10 of the question. 11 Q. I understand you criticize their 12 methodology. 13 A. Yes. 14 Q. But you're not proposing an 15 alternative methodology as to how to arrive at 16 the number that would put TSA back in the same 17 position it would have enjoyed had the RFA not 18 been terminated? 19 A. I didn't do that calculation. I 20 did say that when you're looking at these 21 sorts of instruments, you have to use forward 22 rates and spot rates of interest. 23 Q. We'll talk about that in more 24 detail. 25 A. Okay.</p>

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<p>1 D. Babbel</p> <p>2 Q. So that would be a tool that you</p> <p>3 think is appropriate to use in a valuation</p> <p>4 exercise such as the one presented here?</p> <p>5 A. Forward rates and spot rates,</p> <p>6 yes.</p> <p>7 Q. Okay. If you turn to page 4, one</p> <p>8 of the opinions that you identify is that you</p> <p>9 think it was inappropriate for Mr. Curry and</p> <p>10 Mr. Hasterok to use historically low interest</p> <p>11 rates to compute the flow of cash shortfalls.</p> <p>12 Correct?</p> <p>13 A. Yes.</p> <p>14 Q. Okay. Now, those historically</p> <p>15 low short-term interest rates are interest</p> <p>16 rates reflective of the period from late 2008</p> <p>17 to present. Correct?</p> <p>18 MR. TAMBE: Objection to the form</p> <p>19 of the question.</p> <p>20 A. They were historically low,</p> <p>21 especially in the last three years.</p> <p>22 Q. And do you have a prediction of</p> <p>23 what interest -- short-term interest rates are</p> <p>24 going to be next year?</p> <p>25 A. No.</p>	<p>1 D. Babbel</p> <p>2 and relatively steady during the early '60s</p> <p>3 and particularly the '50s.</p> <p>4 Q. And you have not opined as to</p> <p>5 what an appropriate short-term interest rate</p> <p>6 should be that -- in lieu of what Mr. Curry</p> <p>7 and Mr. Hasterok have suggested. Correct?</p> <p>8 MR. TAMBE: Objection to the form</p> <p>9 of the question.</p> <p>10 A. What a short-term rate should be?</p> <p>11 Q. Well, you're criticizing their</p> <p>12 use of historically low short-term rates, you</p> <p>13 don't have a prediction about the future, and</p> <p>14 I'm just confirming that I didn't miss -- you</p> <p>15 didn't provide an opinion that Mr. Curry or</p> <p>16 Mr. Hasterok should have used X or Y or Z</p> <p>17 instead of the short-term interest rates that</p> <p>18 they use.</p> <p>19 A. I thought I said that they should</p> <p>20 use forward rates. That's -- if you use</p> <p>21 something other than forward rates for</p> <p>22 projections, you end up with free money,</p> <p>23 infinite arbitrage opportunities, inconsistent</p> <p>24 pricing with the market.</p> <p>25 The spot rate tells you what any</p>
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<p>1 D. Babbel</p> <p>2 Q. Five years from now?</p> <p>3 A. I have a direction, but I don't</p> <p>4 have a prediction number.</p> <p>5 Q. Now, are you aware of any other</p> <p>6 period of time where U.S. short-term interest</p> <p>7 rates have remained low and stable for an</p> <p>8 extended period of time?</p> <p>9 A. Not under conditions like we have</p> <p>10 today with massive deficit spending and an</p> <p>11 unprecedented monetary policy of printing</p> <p>12 money as if it's going out of style.</p> <p>13 Q. Do you agree that in the 1950s</p> <p>14 and 1960s, short-term interest rates were low</p> <p>15 over an extended period of time?</p> <p>16 A. They were, during the early '50s</p> <p>17 during the Eisenhower administration. They</p> <p>18 didn't get this low, but they were low. Once</p> <p>19 President Johnson came on, and even partly</p> <p>20 Kennedy, we started seeing some upward</p> <p>21 movement.</p> <p>22 Q. So at least in the '50s through</p> <p>23 the early '60s, interest rates were low and</p> <p>24 steady, though not as low as they are now?</p> <p>25 A. Well, they were relatively low</p>	<p>1 D. Babbel</p> <p>2 cash flow is worth at any future point in</p> <p>3 time, and the forward rate tells you what you</p> <p>4 can lock in at any future point in time.</p> <p>5 So they were using something --</p> <p>6 even the federal government couldn't sell any</p> <p>7 of their debt if they were trying to price it</p> <p>8 the way that Curry and Hasterok are pricing</p> <p>9 it. You can't use historical rates to price</p> <p>10 future interest commitments.</p> <p>11 Q. Well, is it your understanding</p> <p>12 that TSA has the ability to lock in interest</p> <p>13 rates for a 23-year period during the</p> <p>14 remainder of the term of the contract?</p> <p>15 A. TSA would have the ability, as</p> <p>16 anyone would. I can lock in the interest</p> <p>17 rate. You could too. They could too.</p> <p>18 Now, if you ask whether they</p> <p>19 could with these particular funds that were in</p> <p>20 a particular bucket, maybe not. But the</p> <p>21 market can lock in these cash flows.</p> <p>22 Q. But just to be clear, you haven't</p> <p>23 looked at anything about the indenture of the</p> <p>24 bonds that limits the investments that TSA can</p> <p>25 make with respect to the reserve fund, have</p>

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<p>1 D. Babbel</p> <p>2 you?</p> <p>3 A. I've read about it in reports,</p> <p>4 but I haven't looked at the indenture.</p> <p>5 Q. So you can't tell us, based on</p> <p>6 your independent review of the indenture</p> <p>7 whether or not TSA could have locked in rates</p> <p>8 at any particular level or not?</p> <p>9 A. I can't tell you what TSA could</p> <p>10 do.</p> <p>11 Q. And you haven't looked at the</p> <p>12 statutory authority creating TSA to see what</p> <p>13 limitations, if any, exists on their authority</p> <p>14 to invest funds. Correct?</p> <p>15 A. Well, I've read in the reports</p> <p>16 what they say their limitations were.</p> <p>17 Q. Have you done any independent</p> <p>18 investigation to determine what those</p> <p>19 limitations are with respect to the TSA's</p> <p>20 investment authority?</p> <p>21 A. No.</p> <p>22 Q. Forward rates are important if</p> <p>23 you can lock in those rates. Correct?</p> <p>24 MR. TAMBE: Objection to the form</p> <p>25 of the question.</p>	<p>1 D. Babbel</p> <p>2 (Record read.)</p> <p>3 Q. Can I go on to my next question?</p> <p>4 A. Yes.</p> <p>5 Q. Thank you. And, if the word</p> <p>6 "indication" bothers you, let me know. And</p> <p>7 tell me what would be a better word.</p> <p>8 So the forward curve as of March</p> <p>9 25, 2009, indicated a -- how short-term</p> <p>10 interest rates would look from 2009 through</p> <p>11 February 24, 2014. Correct?</p> <p>12 A. No.</p> <p>13 Q. Please correct my statement.</p> <p>14 MR. TAMBE: Objection to the form</p> <p>15 of the question.</p> <p>16 You can answer.</p> <p>17 Q. What is incorrect about my</p> <p>18 question?</p> <p>19 A. How short-term rates should look.</p> <p>20 I think those were your words.</p> <p>21 Q. I want to use the terminology</p> <p>22 that works for you. So you tell me what</p> <p>23 terminology works for you. What does the</p> <p>24 forward rate tell us about -- other than what</p> <p>25 market participants think short-term rates</p>
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<p>1 D. Babbel</p> <p>2 A. Forward rates are important</p> <p>3 whether you can lock them in or not. They</p> <p>4 tell you the price of money at different</p> <p>5 periods of time, today's price of locking</p> <p>6 those in. Whether you can lock it in or not,</p> <p>7 the value is independent of whether you can do</p> <p>8 it.</p> <p>9 Q. Well, if I don't have the</p> <p>10 capability to invest in the ways that are</p> <p>11 necessary to lock in the rates derived from</p> <p>12 the forward curve, what good does it do me?</p> <p>13 A. It tells you what the costs are.</p> <p>14 And it tells you what the market value is.</p> <p>15 Q. It doesn't tell you what the</p> <p>16 value is to me in terms of what I can transact</p> <p>17 in the market. Correct?</p> <p>18 A. It doesn't tell you that.</p> <p>19 Q. Now, you would agree that the --</p> <p>20 and if the word "indication" is wrong, let me</p> <p>21 know.</p> <p>22 A. Can I go back to the last</p> <p>23 question. I don't know that I -- could you</p> <p>24 read that again for me. I think I was</p> <p>25 incomplete in my answer.</p>	<p>1 D. Babbel</p> <p>2 will be, it doesn't tell us anything more than</p> <p>3 that. Right?</p> <p>4 MR. TAMBE: Objection to form.</p> <p>5 A. It doesn't necessarily tell you</p> <p>6 that.</p> <p>7 Q. Okay.</p> <p>8 A. It tells you the price of money</p> <p>9 today to lock in the future commitment. It</p> <p>10 has embedded in it the consensus of the market</p> <p>11 for what the costs of making those commitments</p> <p>12 are.</p> <p>13 Q. So if we look at the forward</p> <p>14 curve as of March 25, 2009, it will -- it</p> <p>15 indicated what the price would be to lock in</p> <p>16 the interest rate as of February 24, 2014.</p> <p>17 Correct?</p> <p>18 A. What the price would be to lock</p> <p>19 in the interest rate as of February 24, yes,</p> <p>20 it would tell you.</p> <p>21 Q. And it would tell you what the</p> <p>22 yield would be as of February 24, 2014, that</p> <p>23 you were locking in. Correct?</p> <p>24 A. It would.</p> <p>25 Q. So is it fair to say that the</p>

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1 D. Babbel
2 yields that appear on the forward curve as of
3 March 25, 2009, are different than the yield
4 that could have been locked in on January of
5 2014, if you had a forward curve, say, on that
6 day?
7 A. Yes.
8 Q. Different than January of 2010?
9 A. It would be different than March
10 26 of 2009.
11 Q. Every day is different?
12 A. Every day.
13 Q. So if we wanted to actually look
14 at the reality of short-term interest rates up
15 to February 24, 2014, there's actual real data
16 that we could look to and say, here are the
17 actual short-term interest rates. Correct?
18 A. Correct.
19 Q. Okay. And I think, as you've
20 just said, if we ran a future curve as of the
21 date of your report, February 24, 2014, it
22 would look different in terms of short-term
23 interest rates on a future curve on March 25,
24 2009. Correct?
25 A. Yes.

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1 D. Babbel
2 Q. And the curve would be lower;
3 that is, the yields along that curve would be
4 substantially lower than the yields on the
5 curve that was generated on March 25, 2009.
6 Correct?
7 MR. TAMBE: Objection to form.
8 A. Are you talking about my report
9 and the chart I did?
10 Q. If you want to reference the
11 chart, that's fine.
12 A. Because those were based on
13 treasuries. So the treasuries have a
14 different market than LIBOR. And, yes, they
15 were lower -- and the forward curves, and also
16 the spot curves.
17 I'm looking at figure 2; which
18 looks at the spot rate curves.
19 Q. The figure 2 is talking about
20 comparing 2002 to 2009. Correct?
21 A. Yes. Maybe I misheard you.
22 Q. That's fine. We can start with
23 this one.
24 And the 2002 curve shows higher
25 yields than the 2009 curve. Correct?

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1 D. Babbel
2 A. Correct.
3 Q. And if we did a curve, dated
4 February 24, 2014, that would show lower
5 yields than the 2009 curve. Is that correct?
6 A. For the treasuries, yes.
7 Q. Would that be different for other
8 short-term instruments?
9 A. Yes.
10 Q. So is it your understanding that
11 there are short-term instruments available --
12 that they are short-term instruments that you
13 would generate a forward curb with respect
14 to -- that would be showing higher yields
15 today than in March of 2009?
16 A. I don't know. I haven't done
17 that. I do know that other short-term
18 interest rate curves are higher than the
19 treasury. I also know that because of the
20 financial crisis, which you are calling the
21 Great Recession, treasury became a safe haven.
22 It pushed up the demand for
23 treasury instruments and pushed their
24 accompanying yields downward, more than any
25 other market. So in LIBOR, you would not see

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1 D. Babbel
2 a spread like this between those two dates, to
3 this degree.
4 Q. Okay. But if we ran a LIBOR
5 curve as of March 25, 2009, and a LIBOR curve
6 as of February 24, 2014, the 2014 curve would
7 show lower yields than the 2009 curve. Is
8 that fair?
9 A. It could be. I haven't looked at
10 that.
11 Q. Okay.
12 A. I will say I looked at a LIBOR
13 six-month rate on those two dates, and they
14 looked about the same.
15 Q. What -- which --
16 A. These two dates here.
17 Q. Okay.
18 A. But I don't know about the entire
19 curve.
20 Q. Just so I understand, what you
21 just said: You looked at the LIBOR six-month
22 rate in 2002 and 2009, and the six-month rate
23 was relatively close in those two periods?
24 A. On the chart, it looked that way
25 to me.

<p style="text-align: right;">Page 114</p> <p>1 D. Babbel</p> <p>2 Q. But you didn't run a curve?</p> <p>3 A. No, I didn't. I just looked at</p> <p>4 the short one.</p> <p>5 Q. Do you agree that short-term</p> <p>6 rates tend to be lower than mid-term rates?</p> <p>7 A. I've seen every kind of shape of</p> <p>8 a yield curve imaginable, and sometimes they</p> <p>9 are and sometimes they aren't.</p> <p>10 Q. Well, you're a professor of</p> <p>11 finance. Would you agree, more often than</p> <p>12 not, that short-term rates are lower than</p> <p>13 mid-term rates?</p> <p>14 A. I would.</p> <p>15 Q. In paragraph 2, you say the</p> <p>16 forward rates and the term structure of</p> <p>17 interest rates as of March 25, 2009 -- I'm</p> <p>18 just trying to reduce that.</p> <p>19 You're saying that the forward</p> <p>20 curve, as of March 25, 2009, would suggest a</p> <p>21 rate substantially higher than that assumed by</p> <p>22 Mr. Curry and Hasterok. Correct?</p> <p>23 A. Yes.</p> <p>24 Q. I don't understand your sentence,</p> <p>25 "To do otherwise, would imply values that have</p>	<p style="text-align: right;">Page 116</p> <p>1 D. Babbel</p> <p>2 use Mr. Curry and Hasterok's assumption, you</p> <p>3 would get a value that's one-seventh as much</p> <p>4 as something, one-fifth as much, something</p> <p>5 like that. That's what a floating rate</p> <p>6 instrument -- where you're just getting the</p> <p>7 coupons. You don't get the principal of what</p> <p>8 it's worth in the marketplace.</p> <p>9 Anyway, it's a small fraction.</p> <p>10 I've never seen anything trade like that.</p> <p>11 That's not how it works. And it's</p> <p>12 inconsistent with valuation principals. The</p> <p>13 forward and spot rate curves tell you what the</p> <p>14 value of money is: any amount of money from</p> <p>15 one dollar to a million dollars or more on any</p> <p>16 particular date.</p> <p>17 Q. So are you saying if I have a</p> <p>18 dollar that I want to lock in a rate of return</p> <p>19 reflected in the forward curve, I can do that?</p> <p>20 I can go someplace, and somebody's going to</p> <p>21 lock me in for a dollar?</p> <p>22 A. You may find someone. Usually,</p> <p>23 it takes a lot more than that.</p> <p>24 Q. The ability to take advantage of</p> <p>25 the information in the forward curve depends</p>
<p style="text-align: right;">Page 115</p> <p>1 D. Babbel</p> <p>2 nothing to do with the values seen in the</p> <p>3 marketplace."</p> <p>4 Could you explain that?</p> <p>5 A. Sure. When you're valuing a</p> <p>6 floating rate leg of a swap, the market</p> <p>7 practice is consistent with finance theory.</p> <p>8 And you use -- you input the forward rates for</p> <p>9 the cash flow projections and then you</p> <p>10 discount by the set of forward rates</p> <p>11 associated with that. When you do so, you get</p> <p>12 a swap that's valued at par, typically.</p> <p>13 If you assume some other --</p> <p>14 something else -- if you input some other</p> <p>15 projected cash flows, such as Mr. Curry and</p> <p>16 Hasterok, and then you discount them by the</p> <p>17 appropriate forward curve, you get something</p> <p>18 that's worth a small fraction of what these</p> <p>19 instruments trade for in the marketplace.</p> <p>20 And so I said -- you read a</p> <p>21 sentence here, but --</p> <p>22 Q. Sorry. It was, "To do others</p> <p>23 would imply values that have nothing to do</p> <p>24 with the values seen in the marketplace."</p> <p>25 A. Right. So for instance, if you</p>	<p style="text-align: right;">Page 117</p> <p>1 D. Babbel</p> <p>2 on the ability to transact freely in the</p> <p>3 market. Correct?</p> <p>4 MR. TAMBE: Objection to the form</p> <p>5 of the question.</p> <p>6 A. No. You can take advantage of it</p> <p>7 because the instruments that you buy all</p> <p>8 reflect that. So you can sell instruments or</p> <p>9 buy instruments --</p> <p>10 Q. No, I'm asking you a question.</p> <p>11 A. -- but they reflect those</p> <p>12 interest rates.</p> <p>13 Q. Right. My question is: You just</p> <p>14 acknowledged, I think, that if I have a</p> <p>15 dollar, I'm not going to get anyone to do</p> <p>16 business with me. You need a lot more than</p> <p>17 that?</p> <p>18 A. Yes.</p> <p>19 Q. My question in follow up to that</p> <p>20 was: In order to take advantage or to reflect</p> <p>21 the information that's in the forward curve, I</p> <p>22 would need to be in a position where I can</p> <p>23 transact in the market. Is that correct or</p> <p>24 not?</p> <p>25 MR. TAMBE: Objection to the form</p>

<p style="text-align: right;">Page 118</p> <p>1 D. Babbel</p> <p>2 of the question.</p> <p>3 THE WITNESS: Can you just read</p> <p>4 it back?</p> <p>5 (Record read.)</p> <p>6 A. To take advantage of or reflect?</p> <p>7 Could you rephrase that question?</p> <p>8 Q. I understand the forward curve</p> <p>9 demonstrates what you believe the</p> <p>10 market-available yield would be. Correct?</p> <p>11 MR. TAMBE: Objection to the form</p> <p>12 of the question.</p> <p>13 Q. Is that correct or not?</p> <p>14 A. The yield curve reflects the</p> <p>15 available yield?</p> <p>16 Q. What's available in the market.</p> <p>17 A. Yes.</p> <p>18 Q. In order for an individual or an</p> <p>19 entity to take advantage of that, in order to</p> <p>20 achieve that yield, I have to be able to</p> <p>21 transact in the market. Is that correct?</p> <p>22 A. You have to be able to qualify to</p> <p>23 transact. So I did five years' worth of this,</p> <p>24 and it cost me \$14,000 for a lot of money.</p> <p>25 And it took very little money on my part to</p>	<p style="text-align: right;">Page 120</p> <p>1 D. Babbel</p> <p>2 rate is speculative."</p> <p>3 Do you see that?</p> <p>4 A. Yes.</p> <p>5 Q. Would you agree that any guess</p> <p>6 about what future interest rates will be is</p> <p>7 speculative?</p> <p>8 A. Any guess is a guess. Some</p> <p>9 guesses are better than others. This is a</p> <p>10 horrible guess.</p> <p>11 Q. But any guess is speculative?</p> <p>12 A. How are you defining</p> <p>13 "speculative" for this purpose?</p> <p>14 Q. How are you defining</p> <p>15 "speculative" as you use the term here?</p> <p>16 A. That we don't know the future.</p> <p>17 Q. So since we don't know the</p> <p>18 future, any assumption about interest rates in</p> <p>19 the future would indeed be speculative.</p> <p>20 Correct?</p> <p>21 MR. TAMBE: Objection to the</p> <p>22 form.</p> <p>23 You can answer.</p> <p>24 A. I say, "Speculative,</p> <p>25 unsupported." It's speculative in that sense.</p>
<p style="text-align: right;">Page 119</p> <p>1 D. Babbel</p> <p>2 lock in all these rates.</p> <p>3 And I think you could do it. I</p> <p>4 imagine TSA could do it for that. That would</p> <p>5 be just part of a rounding error or something.</p> <p>6 Q. That's an assumption on your</p> <p>7 part?</p> <p>8 A. Yes.</p> <p>9 MR. TAMBE: Well, your question</p> <p>10 is a hypothetical, so ...</p> <p>11 MR. LAWRENCE: His statement</p> <p>12 about the TSA was an assumption on his</p> <p>13 part.</p> <p>14 Q. You continued in the next</p> <p>15 paragraph, 3, you provide further criticism of</p> <p>16 the .65 interest rate.</p> <p>17 Do you see that?</p> <p>18 MR. TAMBE: Page 4?</p> <p>19 MR. LAWRENCE: Yes, we're still</p> <p>20 on page 4.</p> <p>21 Q. Do you see that paragraph 3?</p> <p>22 A. In the summary of opinions?</p> <p>23 Q. Yes.</p> <p>24 A. Okay.</p> <p>25 Q. You say, "Using the .65 interest</p>	<p style="text-align: right;">Page 121</p> <p>1 D. Babbel</p> <p>2 They can't point to any financial theory that</p> <p>3 would justify that prediction. They can't</p> <p>4 point to any market praise that would justify</p> <p>5 such a prediction.</p> <p>6 In fact, we have five experts all</p> <p>7 saying forward rates are important. We have</p> <p>8 the entire market saying all forward rates are</p> <p>9 important, including Curry and Hasterok.</p> <p>10 They never used this method</p> <p>11 before. They invented it out of whole cloth,</p> <p>12 and it's laughable. I haven't seen anything</p> <p>13 like this in my 30 years. They would have</p> <p>14 flunked my 101 class in finance.</p> <p>15 Q. I assume you think it's</p> <p>16 laughable, too, that the TSA has lost tens of</p> <p>17 millions of dollars since Lehman defaulted on</p> <p>18 its bankruptcy?</p> <p>19 MR. TAMBE: I don't think</p> <p>20 that's --</p> <p>21 Objection to ---</p> <p>22 A. That's a nonsecretor --</p> <p>23 Q. Is it laughable, sir?</p> <p>24 A. I don't think it's laughable.</p> <p>25 Q. These are taxpayer moneys that</p>

<p style="text-align: right;">Page 122</p> <p>1 D. Babbel</p> <p>2 are being lost. Is that laughable, sir?</p> <p>3 A. I think it's sad that TSA</p> <p>4 invested them in money markets. They had</p> <p>5 other options and you know it.</p> <p>6 Q. What options would you suggest to</p> <p>7 retain the same level of risk that was in the</p> <p>8 RFA, given the constraints the TSA had in the</p> <p>9 bond indenture and in their authorizing</p> <p>10 authority?</p> <p>11 MR. TAMBE: Objection to the form</p> <p>12 of the question.</p> <p>13 A. They could have mimicked</p> <p>14 something like the floating leg of a swap, by</p> <p>15 investing in appropriate money market</p> <p>16 instruments and not throwing away so much</p> <p>17 money.</p> <p>18 Q. What are appropriate money market</p> <p>19 instruments that they could have invested in?</p> <p>20 A. Well, I don't know what TSA is</p> <p>21 limited to. I know that, at least under the</p> <p>22 RFA and the indenture, they had some limits.</p> <p>23 I don't know to what extent they applied, but</p> <p>24 they gave a list of things that they could</p> <p>25 invest in.</p>	<p style="text-align: right;">Page 124</p> <p>1 D. Babbel</p> <p>2 to assume that they would not lose</p> <p>3 principal? Is that the assumption</p> <p>4 you're asking him to make?</p> <p>5 MR. LAWRENCE: That the risk</p> <p>6 profile and that the chance that</p> <p>7 principal would be lost within the RFA</p> <p>8 is mirrored; for example, in an</p> <p>9 alternative instrument.</p> <p>10 So for example, an</p> <p>11 uncollateralized GIC would raise the</p> <p>12 possibility of loss of principal.</p> <p>13 Correct?</p> <p>14 A. An uncollateralized --</p> <p>15 MR. TAMBE: Continuing objection</p> <p>16 to the form of the question.</p> <p>17 Q. Is that correct?</p> <p>18 A. When you said, to mimic the same</p> <p>19 risk, what you did was buy -- you entered into</p> <p>20 a swap agreement, essentially, with a</p> <p>21 counterparty that was going to go bankrupt in</p> <p>22 a few years.</p> <p>23 Are there other counterparties</p> <p>24 that you may enter into that would have a</p> <p>25 similar chance of going into bankruptcy? You</p>
<p style="text-align: right;">Page 123</p> <p>1 D. Babbel</p> <p>2 And money markets, you're paying</p> <p>3 through the nose to get daily liquidity. Why</p> <p>4 does TSA need daily liquidity? Why couldn't</p> <p>5 they get six-month liquidity?</p> <p>6 Q. So my question was: Can you</p> <p>7 identify any other instruments that you</p> <p>8 believe that should have been invested in</p> <p>9 given the indenture requirements and authority</p> <p>10 requirements that would have provided the same</p> <p>11 risk profile as the RFA?</p> <p>12 MR. TAMBE: Objection to the form</p> <p>13 of the question.</p> <p>14 You can answer.</p> <p>15 A. Well, when you say, "the same</p> <p>16 risk profile," how are you defining that?</p> <p>17 Q. I'm defining the risk that the</p> <p>18 TSA would face of nonperformance and including</p> <p>19 loss of principal.</p> <p>20 MR. TAMBE: Objection to the form</p> <p>21 of the question.</p> <p>22 Could you just read back that</p> <p>23 last question?</p> <p>24 (Record read.)</p> <p>25 MR. TAMBE: So you're asking him</p>	<p style="text-align: right;">Page 125</p> <p>1 D. Babbel</p> <p>2 want to replace exactly the same risk. Right?</p> <p>3 Q. I would like to see -- you to</p> <p>4 tell me whether there are other instruments</p> <p>5 that would have the same risk involved. Here,</p> <p>6 the risk was the failure of Lehman to pay</p> <p>7 interest because the dollars were not invested</p> <p>8 in Lehman. Lehman wasn't holding the dollars.</p> <p>9 And so, fortunately, the \$45 million principal</p> <p>10 remains intact.</p> <p>11 So there's a concern, a risk,</p> <p>12 that the TSA has to make sure that that</p> <p>13 principal remains intact?</p> <p>14 A. Yes.</p> <p>15 MR. TAMBE: Objection to the form</p> <p>16 of the question.</p> <p>17 Q. So, we're looking for a financial</p> <p>18 instrument that was available on March 2009,</p> <p>19 that in your estimation would best approximate</p> <p>20 the risk that TSA was trying to address in the</p> <p>21 RFA.</p> <p>22 A. TSA entered into a swap</p> <p>23 agreement. It had a fixed leg and a floating</p> <p>24 leg. Because the fixed leg is not available,</p> <p>25 they could take the same side that Lehman</p>

<p style="text-align: right;">Page 126</p> <p>1 D. Babbel</p> <p>2 took, if they wanted, and invest in floating</p> <p>3 rate instruments.</p> <p>4 The best floating rate</p> <p>5 instruments will have interest rates that</p> <p>6 ensue over time but will provide the return of</p> <p>7 principal at the end of the intervals, the</p> <p>8 same as before.</p> <p>9 And it had the same present</p> <p>10 value, at least at the outset, to Lehman</p> <p>11 Brothers, as it had to TSA, approximately the</p> <p>12 same present value. And undertaking a series</p> <p>13 of investments in the future with a floating</p> <p>14 rate would similarly have a present value that</p> <p>15 reflects the full principal that you have.</p> <p>16 As you represented to me earlier,</p> <p>17 and some of the witnesses represented, the</p> <p>18 fixed leg is precluded right now because of</p> <p>19 unpopularity of the tobacco settlement swaps.</p> <p>20 But you could get a floating leg that is worth</p> <p>21 the same amount of money and invest your money</p> <p>22 similarly to what is actually assumed in the</p> <p>23 swap pricing.</p> <p>24 Q. Let's -- let's just assume --</p> <p>25 well, let's step back because the testimony</p>	<p style="text-align: right;">Page 128</p> <p>1 D. Babbel</p> <p>2 since 2009?</p> <p>3 A. Yes.</p> <p>4 Q. Keep that in mind as we go</p> <p>5 forward in this deposition.</p> <p>6 A. Yes.</p> <p>7 Q. Have you done any calculation of</p> <p>8 what TSA's losses would be if they had, for</p> <p>9 example, purchased government agency</p> <p>10 securities on a six-month basis every six</p> <p>11 months between March 2009 and today?</p> <p>12 A. I haven't done the calculation.</p> <p>13 Q. You could do that. Right?</p> <p>14 We know what they could have</p> <p>15 received, what yield they could have received,</p> <p>16 if they purchased in March 25, 2009. Correct?</p> <p>17 Let's move to the actual date.</p> <p>18 So June 2009, they would have purchased.</p> <p>19 Correct? And we can look at the market data</p> <p>20 and see what yield they could obtain.</p> <p>21 Correct?</p> <p>22 A. Yes.</p> <p>23 Q. And what costs they would incur</p> <p>24 in making that transaction. Correct?</p> <p>25 A. Yes.</p>
<p style="text-align: right;">Page 127</p> <p>1 D. Babbel</p> <p>2 has been that, not just tobacco RFAs, but that</p> <p>3 Reserve Funds Agreements, in general, are not</p> <p>4 available in the market.</p> <p>5 Do you understand that?</p> <p>6 A. Well, that's what you said. I</p> <p>7 don't know --</p> <p>8 Q. That's what Lehman's expert said.</p> <p>9 A. That's fine.</p> <p>10 MR. TAMBE: You're asking him to</p> <p>11 assume that fact. Is that what you're</p> <p>12 asking?</p> <p>13 MR. LAWRENCE: That's what he</p> <p>14 testified to yesterday. So ...</p> <p>15 MR. TAMBE: What are you asking</p> <p>16 this witness for? Not what someone else</p> <p>17 testified to you yesterday. What are</p> <p>18 you asking him to assume for purposes of</p> <p>19 the next question?</p> <p>20 Q. Assume that Lehman's expert is</p> <p>21 correct in that point, that there was no</p> <p>22 active market for Reserve Fund Agreements.</p> <p>23 A. Okay.</p> <p>24 Q. There hasn't been, to his</p> <p>25 knowledge, a Reserve Fund Agreement transacted</p>	<p style="text-align: right;">Page 129</p> <p>1 D. Babbel</p> <p>2 Q. And then you can go six months</p> <p>3 out from there and see what the yields were in</p> <p>4 December of 2009 and do that same exercise</p> <p>5 every six months to date. Correct?</p> <p>6 A. You could.</p> <p>7 Q. And you could compare that actual</p> <p>8 interest that could have been earned with the</p> <p>9 guaranteed interest that Lehman agreed to</p> <p>10 provide. Correct?</p> <p>11 A. Right.</p> <p>12 Q. And that is one way that you</p> <p>13 could determine the loss that TSA suffered, at</p> <p>14 least between 2009 and 2014. Correct?</p> <p>15 A. Assuming that they bought what</p> <p>16 instruments, that they bought money -- the</p> <p>17 money market that they actually purchased?</p> <p>18 Q. I'm just saying, assuming that</p> <p>19 they bought one of the eligible securities</p> <p>20 under the RFA.</p> <p>21 A. Yes, you could calculate that.</p> <p>22 Q. And that would be a reflection of</p> <p>23 the actual loss, in your view, that the TSA</p> <p>24 has suffered between 2009 and 2014. Correct?</p> <p>25 MR. TAMBE: Objection to the form</p>

<p style="text-align: right;">Page 130</p> <p>1 D. Babbel</p> <p>2 of the question.</p> <p>3 You can answer.</p> <p>4 A. No. The loss depends upon the</p> <p>5 value of the instrument. And the value of the</p> <p>6 instrument would reflect all of the future</p> <p>7 possibilities as well.</p> <p>8 Q. Have you read the termination</p> <p>9 amount provision of the RFA?</p> <p>10 A. Yes.</p> <p>11 Q. Does it say anywhere in there</p> <p>12 that the termination amount shall be</p> <p>13 determined by the theoretical value of the</p> <p>14 instrument?</p> <p>15 A. It talks about using market</p> <p>16 quotes, and forward curves are dependent on</p> <p>17 market quotes. So it embraces the notion of</p> <p>18 forward curves because that's how these</p> <p>19 floating rate instruments are valued.</p> <p>20 And when I talk about the value</p> <p>21 of the procedure, we're not just talking about</p> <p>22 the first four years of cost flows. This is</p> <p>23 twenty-three years. And value is going to</p> <p>24 reflect the full length of time that you're</p> <p>25 going to be able to do this.</p>	<p style="text-align: right;">Page 132</p> <p>1 D. Babbel</p> <p>2 what you have stated, and others -- there was</p> <p>3 not an active market for those sorts of</p> <p>4 contracts. But there was, certainly, a very</p> <p>5 active market for both legs of that contract.</p> <p>6 Q. Well, that's not what this -- did</p> <p>7 you read this agreement?</p> <p>8 A. I did.</p> <p>9 Q. Okay. Does the agreement say</p> <p>10 you're supposed to get quotes for some</p> <p>11 different kind of contract, than the RFA?</p> <p>12 A. Well, you can't get quotes for</p> <p>13 the RFA. You have to value it in pieces.</p> <p>14 Q. That's not what it says here,</p> <p>15 does it? Does it say, "If you can't get</p> <p>16 quotes, then you value it in pieces"?</p> <p>17 MR. TAMBE: Objection to the form</p> <p>18 of the question.</p> <p>19 And just if you can, just let him</p> <p>20 finish answering.</p> <p>21 A. If you keep reading, if you go to</p> <p>22 Section 7.6, it says that when you're doing</p> <p>23 such an operation, you have to do it from the</p> <p>24 perspective of the dealer, basically.</p> <p>25 Because dealers are the ones that</p>
<p style="text-align: right;">Page 131</p> <p>1 D. Babbel</p> <p>2 Q. Are you finished?</p> <p>3 A. Well, I can stop now.</p> <p>4 Q. I agree with you, that the first</p> <p>5 step in the process to obtain market quotes</p> <p>6 would typically involve a dealer using the</p> <p>7 forward curve to come up with a market quote.</p> <p>8 We can agree on that.</p> <p>9 A. Yes.</p> <p>10 Q. That would be standard in the</p> <p>11 industry, so to speak?</p> <p>12 A. It would be.</p> <p>13 Q. And I agree, just looking at that</p> <p>14 provision, that it does contemplate that if</p> <p>15 you can get market quotes, that will tell us</p> <p>16 what the value is. Is that correct?</p> <p>17 A. That's correct.</p> <p>18 Q. But market quotes were not able</p> <p>19 to be obtained. Do you have any different</p> <p>20 understanding?</p> <p>21 MR. TAMBE: Objection to the form</p> <p>22 of the question.</p> <p>23 A. Market rates for what?</p> <p>24 Q. For a replacement RFA contract.</p> <p>25 A. Those contracts, according to</p>	<p style="text-align: right;">Page 133</p> <p>1 D. Babbel</p> <p>2 offer this. In fact, they said "Lehman's</p> <p>3 perspective." And that's the way the market</p> <p>4 values these things, and you do it in pieces.</p> <p>5 You do the best you can.</p> <p>6 These instruments are valued all</p> <p>7 the time even though they're not traded. And</p> <p>8 they have to be valued, because they're</p> <p>9 reported mark to market on a daily basis. The</p> <p>10 CME requires that they use forward rates to</p> <p>11 value them.</p> <p>12 The London Clearing House says</p> <p>13 you have to use forward rates to value them,</p> <p>14 and nothing that I've ever read says you have</p> <p>15 to use Hasterok's assumption.</p> <p>16 And had Lehman assumed, or anyone</p> <p>17 assumed, what Hasterok does, they never would</p> <p>18 have entered into the deal. They would have</p> <p>19 said, "Okay. You're giving us \$45 million,</p> <p>20 but it's only worth \$15 million or \$10</p> <p>21 million. Because you're limiting us to only</p> <p>22 earn 65 basis points for the next 23 years."</p> <p>23 Q. So is it correct then that your</p> <p>24 opinion is based on the assumption that the</p> <p>25 TSA loss has to be valued from the dealer side</p>

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1 D. Babbel
2 of the market?
3 MR. TAMBE: Objection to the form
4 of the question.
5 A. It -- you use -- the way I read
6 that -- and I'm not giving a legal opinion,
7 just the way I read the contract -- is that
8 you're supposed to use the typical conventions
9 that dealers would use.
10 Q. So then is your opinion based on
11 that assumption; that is, your opinions about
12 the propriety, the use of the forward curve,
13 et cetera, based on the assumption that you
14 value this from the dealer side of the market
15 using dealer-standard valuation methodologies?
16 A. That's a good question. I would
17 value it the same whether I were the buyer or
18 the dealer, because those are the only values
19 that are traded. So it really doesn't matter.
20 Q. But if TSA can't transact, why do
21 traded values matter to TSA?
22 MR. TAMBE: Objection to the form
23 of the question.
24 You want him to speculate as to
25 what matters to the TSA?

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1 D. Babbel
2 A. The contract has ended. The
3 question is -- in my view, the question is:
4 Did TSA do the best that they could?
5 Investing in money markets is, like, the worst
6 thing you could do from my perspective. I
7 don't know why they did that.
8 Were they trying to go for the
9 lowest possible yield or have daily liquidity
10 so they could gamble on the future and
11 immediately transact when markets jump so they
12 could make a big profit?
13 I don't know what their
14 motivation was. I think they have pretty
15 good -- well, I shouldn't speculate on that.
16 Q. Do you have any reason to believe
17 that TSA was not acting in good faith?
18 MR. TAMBE: Objection to the form
19 of the question.
20 A. I think I could have done a
21 better job of mitigating losses than they did
22 unless they were trying to make a play on the
23 future.
24 Q. My question was whether or not
25 you had any opinion on whether or not the TSA

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1 D. Babbel
2 was acting in good faith?
3 A. No.
4 Q. In fact, it doesn't appear that
5 you have reviewed any of the depositions of
6 the TSA people who were making those
7 decisions. Correct?
8 A. That's correct.
9 Q. Now, the actual RFA provides that
10 if quotations are not available, that the
11 burden party -- who is TSA. You understand
12 that, that TSA is the burden party in this
13 contract?
14 A. That's what I understand.
15 Q. (Reading.) "The termination
16 amount shall be the amount as reasonably
17 determined in good faith by the TSA to be the
18 TSA's total losses and costs."
19 Do you remember that terminology?
20 A. Sure.
21 Q. And how does total losses and
22 costs -- does that tell you you have to use
23 future curves?
24 A. Could you give me the document,
25 please?

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1 D. Babbel
2 Q. Sure.
3 A. (Document review.) Section 5.5
4 talks about termination amounts. And it says
5 the amount owed to Lehman could be
6 substantial.
7 It also -- I remember reading
8 something about material errors, that if the
9 entity doing the valuation -- which in this
10 case would be TSA -- made a -- I forget the
11 exact wording, but it had to do with apparent
12 or material --
13 Q. I think if you look at the end of
14 the termination amount definition we were
15 looking at the beginning of the contract,
16 there's a manifest error. Is that what you're
17 talking about?
18 A. Manifest error.
19 Q. It's in the termination amount
20 definition that we were looking at originally.
21 A. Okay.
22 Q. At the end of that, on the next
23 page.
24 A. I don't know what the definition
25 of a "manifest error" is between economists.

<p style="text-align: right;">Page 138</p> <p>1 D. Babbel</p> <p>2 Curry and Hasterok made it to come up with a</p> <p>3 new method valuation, which I've never seen,</p> <p>4 they've never done. So there's clearly a</p> <p>5 manifest error from an economist's point of</p> <p>6 view.</p> <p>7 Q. Oh, does the termination amount</p> <p>8 definition incorporate from an economist's</p> <p>9 point of view into its definition?</p> <p>10 MR. TAMBE: Objection to the form</p> <p>11 of the question.</p> <p>12 A. I'm an economist. It was</p> <p>13 manifest to me. What else can I say?</p> <p>14 Q. The definition doesn't</p> <p>15 incorporate the standard of an economist</p> <p>16 finance professor at Wharton does it?</p> <p>17 A. It does talk about from Lehman's</p> <p>18 point of view, from the perspective of Lehman</p> <p>19 in Section 7.6.</p> <p>20 I would say that all the experts</p> <p>21 would agree that this is something that</p> <p>22 they've never seen before and never done</p> <p>23 before. And to make a claim for millions and</p> <p>24 millions of dollars from people who are not</p> <p>25 trained in economic things and who come up</p>	<p style="text-align: right;">Page 140</p> <p>1 D. Babbel</p> <p>2 Q. I'm not suggesting you know. I'm</p> <p>3 just asking how do you determine what their</p> <p>4 total losses will be. As you said, there may</p> <p>5 not be losses. You have to go through the</p> <p>6 valuation first. How do you value what the</p> <p>7 total losses will be?</p> <p>8 A. You look at what they could have</p> <p>9 lost in value. That's how I would do it. But</p> <p>10 I'm not the damages expert. I don't know the</p> <p>11 definition of damages.</p> <p>12 They're talking here about a</p> <p>13 termination amount. I know something about</p> <p>14 valuing swaps, fixed pieces, and floating</p> <p>15 pieces.</p> <p>16 My testimony is really restricted</p> <p>17 to methodology and how swaps are -- take</p> <p>18 advantage of or valued by forward rates of</p> <p>19 interest. So I wasn't asked to really do</p> <p>20 this, what you're asking me now.</p> <p>21 Q. Okay. Fair enough. I do need</p> <p>22 that back though.</p> <p>23 A. Sure. (Handing.)</p> <p>24 Q. Have you ever been asked to give</p> <p>25 an opinion about a party's total losses?</p>
<p style="text-align: right;">Page 139</p> <p>1 D. Babbel</p> <p>2 with a model that's ludicrous to value</p> <p>3 something, to me, that's a manifest error.</p> <p>4 They should use standard</p> <p>5 valuation procedures that are consistent with</p> <p>6 the way things are actually valued.</p> <p>7 Q. What's the standard procedure</p> <p>8 when you have a situation, as you've said,</p> <p>9 you've never seen before?</p> <p>10 A. Uh-huh. You look at the pieces</p> <p>11 of the transaction and see if you can value</p> <p>12 them the best you can. Because the contract</p> <p>13 is no longer available, so there's potential</p> <p>14 damages that go to one party or the other.</p> <p>15 And you do the valuation and find out who they</p> <p>16 go to.</p> <p>17 Q. Is there anything unfair or</p> <p>18 inappropriate in the definition of termination</p> <p>19 amount to try to figure out what TSA's actual</p> <p>20 losses will be?</p> <p>21 MR. TAMBE: Objection to the form</p> <p>22 of the question.</p> <p>23 A. What their actual losses will be?</p> <p>24 I don't know that there will be any losses at</p> <p>25 all under this contract.</p>	<p style="text-align: right;">Page 141</p> <p>1 D. Babbel</p> <p>2 MR. TAMBE: Objection to the form</p> <p>3 of the question.</p> <p>4 A. I don't know. I don't think so.</p> <p>5 Q. Okay. When you use the term</p> <p>6 "historically low short-term interest rates,"</p> <p>7 what interest rates are you referring to?</p> <p>8 A. Interest rates during my time,</p> <p>9 since I started looking at it.</p> <p>10 Q. What instrument? When you say</p> <p>11 "interest rates," it could be a money market</p> <p>12 funds, a T-Bill, a --</p> <p>13 A. I'm sorry. Treasuries.</p> <p>14 Q. Treasuries?</p> <p>15 A. Yes.</p> <p>16 Q. You say the 65 -- the .65 percent</p> <p>17 interest rate ignores historical record.</p> <p>18 Do you see that?</p> <p>19 A. Yes.</p> <p>20 Q. It certainly reflects the</p> <p>21 historical record from March 2009 to February</p> <p>22 2014. Correct?</p> <p>23 MR. TAMBE: Objection to the</p> <p>24 form.</p> <p>25 A. I'd have to look at the data.</p>

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<p>1 D. Babbel</p> <p>2 I'd say "no." What it did was reflect one</p> <p>3 interest rate that was available out of four</p> <p>4 years. That interest rate happened to be</p> <p>5 reasonably close to one available four years</p> <p>6 earlier, but the rate fluctuated quite a bit.</p> <p>7 So I looked at that curve. It</p> <p>8 went way up and then way down. So I can't say</p> <p>9 that it's reflective of that four-year period.</p> <p>10 Q. Nor can you say it's not</p> <p>11 reflective. Right?</p> <p>12 A. I can say that I saw the interest</p> <p>13 rate jump way up and way down during that</p> <p>14 period and then jump up again. It depends on</p> <p>15 how you define "reflective."</p> <p>16 Q. So which interest rate jumped up</p> <p>17 between March 2009 and 2014?</p> <p>18 A. I saw a LIBOR plot. I went back</p> <p>19 to 2001 or 2002 and looked at a plot. And I</p> <p>20 already discussed that plot with you after one</p> <p>21 month, three month, six month LIBOR.</p> <p>22 Q. I just want to make sure I</p> <p>23 understood your testimony. You were saying</p> <p>24 that going back to 2001, you see significant</p> <p>25 fluctuations up and down. Correct?</p>	<p>1 D. Babbel</p> <p>2 A. Forward curve has a lot to do</p> <p>3 with financial theory. Linear regression is</p> <p>4 one of many methods used to calculate forward</p> <p>5 curves and spot curves.</p> <p>6 Q. So I understand, linear</p> <p>7 regression is a tool used in financial theory</p> <p>8 by some people to calculate the spot curve or</p> <p>9 forward curve. Correct?</p> <p>10 A. The earliest models back in the</p> <p>11 '70s used that.</p> <p>12 Q. And the forward curve is simply a</p> <p>13 more precise, from a modeling point of view,</p> <p>14 line drawing. Is that fair?</p> <p>15 MR. TAMBE: Objection as to form</p> <p>16 of the question.</p> <p>17 A. No, it's not fair.</p> <p>18 Q. It is just drawing a line based</p> <p>19 on a computer model. Correct?</p> <p>20 A. If you define a curve as a line,</p> <p>21 I guess it's a kind of a line, a non-straight</p> <p>22 line.</p> <p>23 Q. In paragraph 4, you talk about</p> <p>24 the upward sloping of the term structure of</p> <p>25 interest rates. It's more historically</p>
Page 143	Page 145
<p>1 D. Babbel</p> <p>2 A. Yes.</p> <p>3 Q. But my question was: Since 2009,</p> <p>4 have you seen significant fluctuations up and</p> <p>5 down, if you know?</p> <p>6 A. Since 2009?</p> <p>7 Q. Yes.</p> <p>8 A. I haven't looked at that.</p> <p>9 Q. Is linear regression a common --</p> <p>10 commonly used in finance?</p> <p>11 A. A linear regression is commonly</p> <p>12 used in finance.</p> <p>13 Q. You don't have any problem using</p> <p>14 linear -- sorry -- using linear regression is</p> <p>15 not unsupported by financial theory. Correct?</p> <p>16 MR. TAMBE: Objection to the form</p> <p>17 of the question.</p> <p>18 A. It doesn't make any sense to me.</p> <p>19 Q. Other people use it in financial</p> <p>20 theory?</p> <p>21 A. Financial theory does not speak</p> <p>22 to statistical methodology.</p> <p>23 Q. So the forward curve is not --</p> <p>24 does not have anything to do with financial</p> <p>25 theory?</p>	<p>1 D. Babbel</p> <p>2 prevalent at higher levels?</p> <p>3 A. Yes.</p> <p>4 Q. Does the -- I'm just going to use</p> <p>5 the word "forward curve," because it's easier</p> <p>6 for me to say. Is the forward curve always</p> <p>7 upward sloping?</p> <p>8 A. No.</p> <p>9 Q. So you're just talking about the</p> <p>10 upward slope that was present on March 25,</p> <p>11 2009?</p> <p>12 MR. TAMBE: Objection to the form</p> <p>13 of the question.</p> <p>14 A. Well, the upward slope is</p> <p>15 persistent for a while here. It reflects</p> <p>16 market expectations as well as all other</p> <p>17 market information.</p> <p>18 Q. Low interest rates have persisted</p> <p>19 for a while as well. Right?</p> <p>20 A. They have.</p> <p>21 MR. LAWRENCE: Why don't we take</p> <p>22 a break.</p> <p>23 MR. TAMBE: Sure.</p> <p>24 (Recess taken from 2:40 p.m. to</p> <p>25 2:58 p.m.)</p>

<p style="text-align: right;">Page 146</p> <p>1 D. Babbel</p> <p>2 BY MR. LAWRENCE:</p> <p>3 Q. Given what you know about</p> <p>4 financial theory and the functioning of the</p> <p>5 markets, wouldn't you expect some dealer to be</p> <p>6 able to quote a replacement RFA contract in</p> <p>7 March 2009, just on a theoretical basis?</p> <p>8 MR. TAMBE: Objection to the form</p> <p>9 of the question.</p> <p>10 A. I would expect -- more than</p> <p>11 expect I would have an almost certainty that</p> <p>12 they would be able to quote swaps. Whether</p> <p>13 associated with an RFA or not, you'd have to</p> <p>14 ask someone that's closer to the markets, the</p> <p>15 day-to-day market, than I am.</p> <p>16 Q. Well, your financial theory is</p> <p>17 that there's a standard market methodology for</p> <p>18 valuing contracts such as the RFA. Correct?</p> <p>19 A. There is a standard methodology,</p> <p>20 yes.</p> <p>21 Q. And this is not a secret. It's</p> <p>22 known to all of the market participants.</p> <p>23 Correct?</p> <p>24 A. Apparently not, if TSA is saying</p> <p>25 that they use some other way of valuing it.</p>	<p style="text-align: right;">Page 148</p> <p>1 D. Babbel</p> <p>2 Q. So you recognize there's a</p> <p>3 difference between your valuation methodology</p> <p>4 and what a dealer might be willing to</p> <p>5 transact?</p> <p>6 MR. TAMBE: Objection to the form</p> <p>7 of the question.</p> <p>8 A. Could you read back the question?</p> <p>9 (Record read.)</p> <p>10 A. A dealer will have their own</p> <p>11 valuation methodology, not necessarily my</p> <p>12 valuation methodology, but something that's</p> <p>13 consistent with it. And he may not be in the</p> <p>14 market to transact for that particular</p> <p>15 instrument, but they can still value it. We</p> <p>16 did that all the time at Goldman Sachs.</p> <p>17 Q. Well, you've got a lot of market</p> <p>18 players who are capable of applying similar</p> <p>19 financial models to yours to value this</p> <p>20 contract, the transactions under this</p> <p>21 contract. Correct?</p> <p>22 A. Yes.</p> <p>23 Q. Okay. But none of them were</p> <p>24 willing to actually transact. Correct?</p> <p>25 MR. TAMBE: Objection to the form</p>
<p style="text-align: right;">Page 147</p> <p>1 D. Babbel</p> <p>2 Q. Well, they're not a dealer, but</p> <p>3 I'm asking from the dealer's point of view.</p> <p>4 This is a well-understood theory of using</p> <p>5 forward curves to value contracts such as</p> <p>6 this. Correct?</p> <p>7 A. Yes.</p> <p>8 Q. And it should have been a</p> <p>9 relatively straightforward exercise for a</p> <p>10 dealer to value this contract in 2009.</p> <p>11 Correct?</p> <p>12 A. They had to do it daily.</p> <p>13 Q. And thus it should have been</p> <p>14 relatively straightforward for a dealer to</p> <p>15 provide a quote to the TSA to provide some</p> <p>16 type of replacement contract?</p> <p>17 MR. TAMBE: Objection to the form</p> <p>18 of the question.</p> <p>19 A. I think that's a non sequitur.</p> <p>20 Q. Why?</p> <p>21 A. I could come up with a value, but</p> <p>22 that doesn't mean I'm going to quote. I may</p> <p>23 not be interested in that particular</p> <p>24 instrument. That doesn't mean I can't figure</p> <p>25 out what it's worth.</p>	<p style="text-align: right;">Page 149</p> <p>1 D. Babbel</p> <p>2 of the question.</p> <p>3 A. I don't know if some of them</p> <p>4 were. What I know is TSA didn't find anyone</p> <p>5 that was. I don't know how much canvassing</p> <p>6 they did. I know that Curry and Hasterok</p> <p>7 purported that there wasn't, even though their</p> <p>8 own firm was offering quotes, according to</p> <p>9 Mr. Hasterok, on such instruments.</p> <p>10 Q. In 2009?</p> <p>11 A. I think he said that the</p> <p>12 Lehman -- sorry, not the Lehman desk but</p> <p>13 Morgan Stanley desk. He mentioned it. Page</p> <p>14 109, or something, he said something like</p> <p>15 that. I couldn't swear to that particular</p> <p>16 number. I have a lot of numbers in my head.</p> <p>17 And not only them. Wachovia</p> <p>18 apparently made some sort of quote that they</p> <p>19 were apparently willing to transact at.</p> <p>20 Q. I'm sorry. Is it your</p> <p>21 understanding that the Wachovia quote was a</p> <p>22 quote that they were willing to transact at?</p> <p>23 A. I think so, but I don't know for</p> <p>24 sure. I'd have to go back and review the</p> <p>25 testimony.</p>

<p style="text-align: right;">Page 150</p> <p>1 D. Babbel</p> <p>2 Q. Was it fact that you think</p> <p>3 Wachovia provided a quote that they were</p> <p>4 willing to transact something that supports,</p> <p>5 in your view, your opinions in this case?</p> <p>6 A. No.</p> <p>7 Q. Can you explain why -- if there</p> <p>8 are financial models that everyone uses in the</p> <p>9 market that are substantially similar, that</p> <p>10 can easily value this contract -- nobody was</p> <p>11 willing to transact an alternative contract?</p> <p>12 MR. TAMBE: Objection to the form</p> <p>13 of the question.</p> <p>14 A. I don't know that nobody was</p> <p>15 willing to. I just know that Mr. Shapiro</p> <p>16 apparently asked some people, but he didn't</p> <p>17 keep track of who he asked and what they said.</p> <p>18 And Mr. Hasterok or Curry asked a</p> <p>19 couple of people. I'm assuming that the</p> <p>20 market was thin or dried up entirely. But</p> <p>21 that doesn't mean the cash flows associated</p> <p>22 with the original contract couldn't be</p> <p>23 mimicked and priced.</p> <p>24 Q. Doesn't the fact that the market</p> <p>25 is unwilling to transact, provide some</p>	<p style="text-align: right;">Page 152</p> <p>1 D. Babbel</p> <p>2 Q. The forward curve, as we've</p> <p>3 talked about, is based on data from market</p> <p>4 transactions. Why isn't the inability or the</p> <p>5 lack of a transaction a relevant piece of data</p> <p>6 that should be considered?</p> <p>7 A. Because there were thousands of</p> <p>8 transactions on the same LIBOR curve during</p> <p>9 any given day.</p> <p>10 Q. But there hasn't been a</p> <p>11 transaction in an RFA since 2009. Why isn't</p> <p>12 that data relevant?</p> <p>13 A. You can get the same amount of</p> <p>14 dollars on some other kind of instrument. The</p> <p>15 fixed rate back in 2009 was about 5-something</p> <p>16 percent. They were being offered 4.484.</p> <p>17 It's just that TSA, because of</p> <p>18 their indenture, wasn't able to take advantage</p> <p>19 of that. So that means they would have to do</p> <p>20 the floating rate leg, which is worth the same</p> <p>21 amount of money, if you're trying to figure</p> <p>22 out how much money was lost and what it's</p> <p>23 worth.</p> <p>24 Q. I'm just trying to understand why</p> <p>25 it is that you take into account certain</p>
<p style="text-align: right;">Page 151</p> <p>1 D. Babbel</p> <p>2 indication of the value of the contract?</p> <p>3 MR. TAMBE: Objection to the form</p> <p>4 of the question.</p> <p>5 A. Assuming the market was unwilling</p> <p>6 to transact, I presume there would be a price,</p> <p>7 some price that would induce someone to go</p> <p>8 into it. But to me, it doesn't indicate the</p> <p>9 value of the floating leg rate of a swap or a</p> <p>10 fixed leg rate of a swap.</p> <p>11 Q. I thought -- sorry.</p> <p>12 A. That's enough.</p> <p>13 Q. Well, it's correct that you would</p> <p>14 assume that somebody would be willing to</p> <p>15 transact at some price, because that's</p> <p>16 consistent with your financial theory,</p> <p>17 correct, about how markets operate?</p> <p>18 A. Yeah. And you'd think at some</p> <p>19 price you could attract someone. I don't know</p> <p>20 what that price would be. But it's not</p> <p>21 particularly relevant.</p> <p>22 Because what you're looking for</p> <p>23 is what the value of the two legs happen to be</p> <p>24 on the day of the termination, or rejection, I</p> <p>25 should say.</p>	<p style="text-align: right;">Page 153</p> <p>1 D. Babbel</p> <p>2 market data but then refuse to take into</p> <p>3 account other market data?</p> <p>4 MR. TAMBE: Objection to the form</p> <p>5 of the question.</p> <p>6 A. I'm looking at the present value</p> <p>7 of a cash flow strain. We already talked</p> <p>8 about the fixed rate leg and we talked about</p> <p>9 the floating rate leg. The present values can</p> <p>10 be determined, and you can get pretty accurate</p> <p>11 valuations on those.</p> <p>12 Whether TSA had restricted itself</p> <p>13 through an indenture or something to take</p> <p>14 advantage of certain legs of the transaction,</p> <p>15 they nonetheless had all the money. And the</p> <p>16 transactions had the same -- the legs have the</p> <p>17 same value whether TSA can take advantage of</p> <p>18 one leg or the other.</p> <p>19 Q. Did you take into account the</p> <p>20 mandatory cleanup call provision of the RFA?</p> <p>21 A. Yes, I read it. It means there's</p> <p>22 a potential cancellation TSA could do. I</p> <p>23 looked at whether there was optionality</p> <p>24 involved. There isn't in the financial sense,</p> <p>25 but there is in a legal sense, I suppose.</p>

<p style="text-align: right;">Page 154</p> <p>1 D. Babbel</p> <p>2 The financial sense optionality</p> <p>3 means you can willfully do something just</p> <p>4 because you find an advantage to doing so.</p> <p>5 And instead, this was precipitated by</p> <p>6 something outside their control.</p> <p>7 Q. Are you aware of any swap</p> <p>8 transactions where an event -- I don't know if</p> <p>9 that's a word you feel comfortable -- but an</p> <p>10 event can trigger a par call?</p> <p>11 A. Sure, cancellable-type swaps.</p> <p>12 And in this particular case, it must have been</p> <p>13 embedded in the original agreement that</p> <p>14 pricing would have reflected the fact that TSA</p> <p>15 had this cancellation provision that might be</p> <p>16 invoked.</p> <p>17 Q. So a callable swap might have</p> <p>18 been an appropriate alternative investment</p> <p>19 vehicle for TSA?</p> <p>20 MR. TAMBE: Objection to the form</p> <p>21 of the question.</p> <p>22 A. I talked about cancellable swaps.</p> <p>23 Q. Maybe I'm misunderstanding the</p> <p>24 distinction between callable and cancellable.</p> <p>25 A. Yeah. Cancellable was outside of</p>	<p style="text-align: right;">Page 156</p> <p>1 D. Babbel</p> <p>2 A. I analogize the facility with</p> <p>3 which you can calculate forward rates as that</p> <p>4 equation, 5 plus "X" equals 8.</p> <p>5 Q. Well, just so we understand: 5</p> <p>6 plus 3 equals 8 today, tomorrow, the next day.</p> <p>7 It always equals 8. Correct?</p> <p>8 A. Yes.</p> <p>9 Q. But as you've indicated, the</p> <p>10 forward curve on March 25 is going to give a</p> <p>11 different algebraic equation than a forward</p> <p>12 curve is on December 24 or 25. Well, the 25th</p> <p>13 is a holiday. You probably don't have too</p> <p>14 many transactions on it. Correct?</p> <p>15 A. Correct.</p> <p>16 Q. So the notion that X is not</p> <p>17 speculative and is reliable and ambiguous,</p> <p>18 only pertains to the one day for which the</p> <p>19 forward curve is calculated. Fair?</p> <p>20 MR. TAMBE: Objection to the form</p> <p>21 of that question.</p> <p>22 A. I wouldn't state it that way. I</p> <p>23 would just state that X is the solution to the</p> <p>24 equation, and it's always that solution to</p> <p>25 that equation. Every day there's another</p>
<p style="text-align: right;">Page 155</p> <p>1 D. Babbel</p> <p>2 the volition of the TSA, as I understand it.</p> <p>3 And so it doesn't invoke the option pricing.</p> <p>4 Instead, it invokes actuarial type pricing</p> <p>5 where you look at probabilities.</p> <p>6 It's sort of like mortgage</p> <p>7 backed -- well, no. Mortgage-backed</p> <p>8 securities actually -- some of the</p> <p>9 mortgage-backed securities have options in</p> <p>10 them where people will cancel them en masse</p> <p>11 because of an interest rate change.</p> <p>12 But these are, sort of, outside</p> <p>13 the control of TSA. So you just put</p> <p>14 expectations on it and you price it.</p> <p>15 Q. You didn't calculate the pricing</p> <p>16 of what a cancellable swap would be in March</p> <p>17 2009. Right?</p> <p>18 A. No.</p> <p>19 Q. Or what it would have earned in</p> <p>20 terms of a floating rate?</p> <p>21 A. No.</p> <p>22 Q. If you turn to page 6 of your</p> <p>23 report. At the bottom of page 6, you</p> <p>24 analogize the forward rate to the algebraic</p> <p>25 equation, 5 plus "X" equals 8. Correct?</p>	<p style="text-align: right;">Page 157</p> <p>1 D. Babbel</p> <p>2 equation, and you can solve for the new X.</p> <p>3 Q. But you can't, you can't use the</p> <p>4 equation -- unlike 5 plus X equals 8, which is</p> <p>5 always true, you can't use the equation to</p> <p>6 determine actual interest rates one or two</p> <p>7 years from now, or three or four years from</p> <p>8 now. Correct?</p> <p>9 A. I wouldn't use 5 plus X equals 8</p> <p>10 to determine interest rates. I'm not sure</p> <p>11 what you mean.</p> <p>12 Q. You can't use the forward curve</p> <p>13 to determine interest rates five, ten,</p> <p>14 fifteen, twenty years out. Correct?</p> <p>15 A. You can use forward rates how you</p> <p>16 want to. Some people might use it for that</p> <p>17 purpose.</p> <p>18 Q. But that would be speculating.</p> <p>19 A. Well, it could be reasoned</p> <p>20 through various other principals. The forward</p> <p>21 rates reflect the best information the market</p> <p>22 has, not only on future interest rates, but on</p> <p>23 credit risk and on liquidity and everything</p> <p>24 else the market puts into that calculation of</p> <p>25 a forward rate.</p>

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1 D. Babbel
2 So some people try to extract the
3 other information and find out the pure,
4 implicit forecast that might be in the forward
5 rate. And other people say that you don't
6 accept those assumptions.
7 Q. What about you?
8 A. I've looked at forward rates, and
9 I've looked at all sorts of ways of
10 forecasting future interest rates. I've read
11 the literature. I must have read a -- I'm
12 just guessing -- 40 or 50 papers on it.
13 Q. Do you --
14 MR. TAMBE: You want to let him
15 finish his answer.
16 MR. LAWRENCE: I thought he was
17 finished.
18 A. There's a mixed response. Some
19 people have better success with them than
20 others, depending on what else they put in
21 their model to filter out the other factors.
22 Q. Do you believe that's an accurate
23 way to forecast interest rates five years out?
24 MR. TAMBE: Objection to the form
25 of the question.

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1 D. Babbel
2 You can answer.
3 A. Well, earlier on in the
4 deposition, we talked about "reliable." I
5 said, "What's reliable? One basis point out
6 of 100?" And I think I said 6.4 or 6.42 or
7 something like that. And you said, "Let's
8 start with that."
9 I have the same problem with the
10 question you just gave. Do you think that
11 forward rates give an accurate prediction of
12 future spot rates of interest? I don't know.
13 If you had asked the question:
14 "Are they better than other forecasting
15 techniques?" They're better than a lot of
16 forecasting techniques. I've read a lot of
17 papers showing that. But a forward rate can
18 only reflect the information we have available
19 today, and tomorrow is another day.
20 I would say the same thing about
21 the stock market. You can't predict the
22 dividends and the earnings of companies in the
23 future very well. Neither can I. And yet the
24 market has a price that it's worth today. And
25 we have to transact at that price. We don't

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2 get the choice.
3 Well, we get the choice not to
4 buy or not to sell, but we don't get to pick
5 our own value. Because no one is going to do
6 that. They use the market value.
7 Q. TSA would have liked any value,
8 but they couldn't get any from a market quote?
9 MR. TAMBE: Objection to the form
10 of the question.
11 MR. LAWRENCE: Strike that.
12 Q. On the next page, you state --
13 this is in the bottom paragraph there -- "In
14 particular, note that the near-term rates for
15 March 2009 are very low, and then from that
16 point the interest rate rises quite steadily."
17 Do you see that?
18 A. Where is that?
19 Q. Bottom of page 7.
20 A. Yes, they are very low. That's
21 right.
22 Q. Is it fair that near-term rates
23 are typically very low compared to other
24 rates?
25 A. No. We already talked about the

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2 term structure, and it's typical that maybe 70
3 percent of the time -- I've seen some studies,
4 some historical studies. About 70 percent of
5 the time, the near-term rate is lower than the
6 rate two years later or three years later.
7 But I've seen also near-term rate at 18 to 21
8 percent and the long-term at 12.
9 Q. I assume you would acknowledge
10 that was in another anomalous period in the
11 late '70s. Correct?
12 A. It was certainly a period of a
13 lot of volatility and uncertainty.
14 Q. Can you turn to page 9.
15 A. Yes.
16 Q. The second full paragraph
17 includes, "I conclude that Messrs. Curry and
18 Hasterok's calculation of the termination
19 amount will certainly yield TSA substantially
20 more than the TSA contracted for with LBSF and
21 RFA."
22 Do you see that?
23 A. Yes.
24 Q. I need your help in understanding
25 that. How will the termination amount yield

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2 substantially more than what TSA contracted
3 for?
4 A. Let me look at the full
5 paragraph. Just a second.
6 Q. Sure.
7 A. (Document review.) Well, yes,
8 they did three things in their calculation,
9 all of which inflate the value to TSA of the
10 contract.
11 Q. And I understand your opinion on
12 that. I'm just trying to specifically
13 understand this sentence.
14 What is the yield that TSA
15 contracted for? Maybe that's what I'm trying
16 to figure out. I mean, TSA contracted for a
17 guaranteed rate of 4.484 percent.
18 A. Okay. I see. Maybe the choice
19 of my word "yield" is signifying to you
20 something to you other than I intended. I
21 could have used the word "give," "provide,"
22 "earn," something else. I don't mean an
23 interest rate. I mean a return.
24 Q. So again, I'm trying to
25 understand, TSA contracted to get 4.484

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2 percent from Lehman Brothers. Correct?
3 A. That's right. And also to give
4 them a floating rate opportunity to invest 45
5 million for some 20-plus years.
6 Q. Right. But I'm saying, from
7 TSA's point of view, they gave over \$45
8 million every six months, and they got back
9 4.484 percent?
10 A. Plus 45 million.
11 Q. Plus 45 million, exactly.
12 So how does Curry and Hasterok's
13 calculation yield or earn more than that?
14 A. Curry and Hasterok were taking
15 some historical average rate over four months,
16 or something like that, and assuming it goes
17 on forever. And instead of -- that's one
18 problem.
19 The second problem is that they
20 discounted it, not by the rate the whole
21 market uses, but they discounted it by that
22 similar rate. They set their cash flows based
23 upon that same rate prevailing.
24 Well, that same rate hasn't
25 prevailed maybe one or two days out of the

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2 last four years, .65, it's always changing
3 each day. They assumed it for the next 23
4 years. There's never been a period in our
5 history like that.
6 If you ask any economist or just
7 ask the market: What are you predicting, or
8 what are you thinking about the future?
9 They're saying we face some very rough water
10 ahead because of the monetary policy that
11 we've undertaken as well as our fiscal policy.
12 So inflation is down the road.
13 We just don't know when it's going to hit.
14 But when it does, interest rates reflect the
15 inflation rate.
16 Q. Let me ask it a different way.
17 Do you have an opinion as to what
18 earnings TSA contracted for with Lehman
19 Brothers in the RFA?
20 A. I have an understanding that TSA
21 contracted for 4.484 percent.
22 Q. And how is Curry and Hasterok's
23 calculation of the termination amount going to
24 yield more than what TSA contracted for?
25 A. We don't know what it's going to

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2 yield. We only know one thing -- and I'd
3 stake my reputation on this -- that it's not
4 going to be -- that the markets are not going
5 to provide 0.65 percent from now for the next
6 23 years. There's zero percent chance of that
7 happening.
8 Q. And would you agree there's a
9 zero percent chance of the market providing
10 the yields reflected in the forward curve as
11 of March 25, 2009, over the next 23 years?
12 A. I would agree that the market
13 will provide more or less than the forward
14 curve. Some years more; some years less.
15 Q. If I bought a ten-year treasury
16 on March 25, 2009, and my partner buys
17 six-month treasury bills -- buys six-month
18 treasury bills every six months for ten years,
19 do you believe that they're going to end up in
20 the same place in terms of the amount of money
21 they've earned over that ten-year period?
22 A. I don't know.
23 Q. You can't tell based on the
24 forward curve. Correct?
25 A. No.

<p style="text-align: right;">Page 166</p> <p>1 D. Babbel</p> <p>2 Q. Is that correct?</p> <p>3 A. That's correct.</p> <p>4 Q. If you turn to page 12, you have</p> <p>5 two -- you have a chart on page 12 and a chart</p> <p>6 on page 13 showing curves. What is the point</p> <p>7 of those two charts?</p> <p>8 A. Two points: First, that the term</p> <p>9 structures -- the spot rates are extremely</p> <p>10 important in valuing things, so important that</p> <p>11 the treasury goes through the trouble of</p> <p>12 calculating every single day of the year. Not</p> <p>13 only the treasury, but now we have all these</p> <p>14 other private corporations that are trying to</p> <p>15 get a more refined calculation.</p> <p>16 Secondly, that the treasury</p> <p>17 calculates the forward rates every day for</p> <p>18 every year since 1960, not just the U.S.</p> <p>19 Treasury, but every other place. Like Goldman</p> <p>20 Sachs, like Lehman Brothers, like Merrill</p> <p>21 Lynch, like just about every other trading</p> <p>22 house, calculates these forward curves and</p> <p>23 spot curves every day; in fact, every minute of</p> <p>24 the day because they're important in valuing</p> <p>25 instruments.</p>	<p style="text-align: right;">Page 168</p> <p>1 D. Babbel</p> <p>2 then you can use -- the second tier would be</p> <p>3 to mark the model. Then the model needs to be</p> <p>4 consistent with things that are accurately</p> <p>5 traded, which tell you the value of money at</p> <p>6 different points in time for future delivery.</p> <p>7 Q. So you're talking about the FAS</p> <p>8 150?</p> <p>9 A. I think it's 150.</p> <p>10 Q. What's owed by Level III assets?</p> <p>11 A. What about them?</p> <p>12 Q. How do you value those?</p> <p>13 MR. TAMBE: Objection to the form</p> <p>14 of the question.</p> <p>15 A. I don't remember. I remember</p> <p>16 reading it.</p> <p>17 Q. Do you know whether or not banks</p> <p>18 consider Tobacco RFA's to be Level III assets</p> <p>19 or Level II assets?</p> <p>20 A. I don't know.</p> <p>21 Q. And you don't have an opinion as</p> <p>22 to whether it's a Level II asset or Level III</p> <p>23 asset. Is that correct?</p> <p>24 A. That's correct.</p> <p>25 Q. Okay. If you turn to page 14.</p>
<p style="text-align: right;">Page 167</p> <p>1 D. Babbel</p> <p>2 And I just want to show you some</p> <p>3 evidence of that. Because it sounded like</p> <p>4 from the report -- until I heard the</p> <p>5 depositions from the report of Curry and</p> <p>6 Hasterok, it sounded like they were eschewing</p> <p>7 the use of forward and spot rates when they're</p> <p>8 primary tools in the valuation in the</p> <p>9 marketplace. Now, their depositions said that</p> <p>10 they agreed, then they always used them</p> <p>11 themselves.</p> <p>12 Q. The disagreement is whether or</p> <p>13 not forward curves are a usable tool for a</p> <p>14 contract that is not being transacted. And I</p> <p>15 know you think it's okay, and they think it's</p> <p>16 not.</p> <p>17 A. Uh-huh.</p> <p>18 Q. Is there any publication that you</p> <p>19 can point to that gives us guidance as to how</p> <p>20 we should value when there's no market to</p> <p>21 transact in a certain asset?</p> <p>22 A. Sure. The Accounting Standards</p> <p>23 Board has produced a hierarchy for use in</p> <p>24 valuation and reporting. And what they say</p> <p>25 is: If you cannot find active trades, quotes,</p>	<p style="text-align: right;">Page 169</p> <p>1 D. Babbel</p> <p>2 A. (Complying.)</p> <p>3 Q. You have a Table 1. Do you see</p> <p>4 that?</p> <p>5 A. Yes.</p> <p>6 Q. And these are published by the</p> <p>7 Fed Reserve Board?</p> <p>8 A. Yes, economists that were</p> <p>9 contracted by them and one of them who works</p> <p>10 with them.</p> <p>11 Q. And what does that tell us</p> <p>12 about -- just so I can understand the table --</p> <p>13 it says, "Year 1, spot rates of interest, .66</p> <p>14 percent. Forward rates of interest .92</p> <p>15 percent."</p> <p>16 What is that telling me?</p> <p>17 A. Yes. From time 0 to time 1, the</p> <p>18 amount of yield you can get for a one-year</p> <p>19 instrument is .66 percent. And the forward</p> <p>20 rate of interest for time 1 to time 2 is 0.92</p> <p>21 percent. So that's one year looking forward.</p> <p>22 Q. I'm sorry. Is that -- I just</p> <p>23 want to make sure I understand. Are you</p> <p>24 saying that the -- that the .92 percent</p> <p>25 interest is what you need to earn in the</p>

<p style="text-align: right;">Page 170</p> <p>1 D. Babbel</p> <p>2 second year to get to the .95 percent spot</p> <p>3 rate?</p> <p>4 A. Good question. I need to check</p> <p>5 that.</p> <p>6 I looked at it, and I can't</p> <p>7 remember right now.</p> <p>8 Q. But if I were buying a one-year</p> <p>9 treasury on March 25, 2009, I'd be able to get</p> <p>10 .66 percent interest for that one-year</p> <p>11 treasure. Correct?</p> <p>12 A. Yes. That's their spot rate.</p> <p>13 And that's based on treasury bonds and not the</p> <p>14 bills.</p> <p>15 Q. Sorry.</p> <p>16 A. The treasury also uses a slight</p> <p>17 smoothing routine that isn't used by all the</p> <p>18 market -- by some market participants. So you</p> <p>19 get a smoother curve when the treasury does</p> <p>20 it. That's just their preference.</p> <p>21 Q. Are you familiar with ISDA?</p> <p>22 A. I know of it, yes.</p> <p>23 Q. What is ISDA?</p> <p>24 A. It's a protocol for swaps and</p> <p>25 derivatives, and that's the S and the D.</p>	<p style="text-align: right;">Page 172</p> <p>1 D. Babbel</p> <p>2 derivative?</p> <p>3 A. I would define a derivative as</p> <p>4 something whose value depends upon the value</p> <p>5 of something else.</p> <p>6 Q. Based on that definition, do you</p> <p>7 consider the TSA RFA to be a derivative</p> <p>8 transact?</p> <p>9 A. I don't opine on that. What I</p> <p>10 opine on is that it could be valued using</p> <p>11 methods that are appropriate for derivatives</p> <p>12 and nonderivatives.</p> <p>13 Q. Isn't the RFA securities</p> <p>14 transaction what a dealer would typically</p> <p>15 hedge using derivative transactions?</p> <p>16 MR. TAMBE: Objection to the form</p> <p>17 of the question.</p> <p>18 A. I don't know whether a dealer</p> <p>19 would typically hedge it. I know that dealers</p> <p>20 can hedge it, at least to some extent.</p> <p>21 Q. Well, with your experience in the</p> <p>22 marketplace, you don't know whether or not</p> <p>23 dealers would typically hedge an RFA</p> <p>24 transaction?</p> <p>25 A. I know what Goldman would do, and</p>
<p style="text-align: right;">Page 171</p> <p>1 D. Babbel</p> <p>2 Q. You're right. Do you understand</p> <p>3 how it's used in the industry?</p> <p>4 A. Well, they have, sort of --</p> <p>5 MR. TAMBE: Objection to the form</p> <p>6 of the question. "How" -- what's --</p> <p>7 "used in the industry"?</p> <p>8 MR. LAWRENCE: The ISDA master</p> <p>9 contract and schedule are used in the</p> <p>10 industry.</p> <p>11 A. So that's -- now you took away my</p> <p>12 answer. That's what I was going to say. They</p> <p>13 have a master, sort of, a standard form</p> <p>14 agreement that can be modified. But that's</p> <p>15 the standard, a starting place.</p> <p>16 Q. Was the TSA RFA subject to the</p> <p>17 ISDA master schedule?</p> <p>18 A. Don't know.</p> <p>19 Q. Is the TSA RFA a derivative</p> <p>20 transaction?</p> <p>21 MR. TAMBE: Objection to the form</p> <p>22 of the question.</p> <p>23 A. How are you defining a</p> <p>24 derivative?</p> <p>25 Q. How would you define a</p>	<p style="text-align: right;">Page 173</p> <p>1 D. Babbel</p> <p>2 I have an understanding of what most dealers</p> <p>3 do. They try to lock in a profit and hedge</p> <p>4 out the rest and move on.</p> <p>5 Q. Do you know what Lehman did in</p> <p>6 this case?</p> <p>7 A. No.</p> <p>8 Q. So on page 19, you identify four,</p> <p>9 I guess, economic theories -- sorry, 15. On</p> <p>10 page 15, you talk about four theories, regard</p> <p>11 that one might use to look at future levels of</p> <p>12 interest rates. Is that correct?</p> <p>13 A. Yes.</p> <p>14 Q. And would you agree that all four</p> <p>15 of those theories would have predicted</p> <p>16 different interest rates for the period 2009</p> <p>17 to 2014 than in actuality occurred?</p> <p>18 A. I don't know. I haven't -- the</p> <p>19 theories are -- they're not that simple that I</p> <p>20 could respond without doing some calculations.</p> <p>21 Q. On page 16, in the middle of the</p> <p>22 paragraph on that page, you say Messrs. Curry</p> <p>23 and Hasterok have simply ignored the fact that</p> <p>24 to make forward commitments, the providing</p> <p>25 institution, LBSF, will have to incur the</p>

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<p>1 D. Babbel 2 market costs of doing so. And those market 3 costs are reflected in the term structure of 4 interest rates." 5 Do you see that? 6 A. Yes, yes. 7 Q. Can you help me -- explain that 8 sentence to me. 9 A. Yes. Mr. Curry and Hasterok 10 have -- let me start over again. 11 Lehman Brothers and LBSF are 12 going to be making commitments, putting Lehman 13 on the line for a number of years in the 14 future. 15 And if they're going to be 16 providing payments to TSA, they have to figure 17 out how to get those payments and the 18 appropriate amounts to TSA. 19 A typical dealer will not just go 20 naked on it. They will hedge it, and they 21 will find market instruments that provide 22 those sorts of cash flows. 23 Q. When you say "market costs," 24 you're talking about of obtaining hedges? 25 A. Yes.</p>	<p>1 D. Babbel 2 methodology, but I didn't verify anything, 3 replicate anything. I was not asked to do any 4 valuations. 5 Q. You were not asked to provide any 6 opinion, at least as far as I see in your 7 report, about swaps? 8 A. About swaps? 9 Q. About the SWAP Financial 10 calculation? 11 A. That's correct. 12 MR. LAWRENCE: Why don't we take 13 five minutes and see if we're about 14 done. 15 MR. TAMBE: Okay. 16 (Recess taken from 3:43 p.m. to 17 3:53 p.m.) 18 (Continued on the next page.) 19 20 21 22 23 24 25</p>
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<p>1 D. Babbel 2 Q. Now, you reviewed the valuation 3 matrix that was prepared by Messrs. Curry and 4 Hasterok? 5 A. I read about it. 6 Q. One of the items on the matrix 7 was a callable swap, and it had a yield 8 associated with that. 9 Do you recall that? 10 A. I recall that. 11 Q. Did you do any research to 12 determine whether or not they used the correct 13 yield for that type of instrument? 14 A. No. 15 Q. Did you do any research to 16 determine whether or not the yields identified 17 in the valuation matrix were accurate or not? 18 A. No. That was not my task. 19 Q. And I take it you were not asked 20 to review the calculation of SWAP 21 Financials. Is that correct? 22 A. That's right. Let me say, your 23 question was not asked to review the 24 calculation. So that's correct. I did not 25 review the calculation. I did look at the</p>	<p>1 D. Babbel 2 BY MR. LAWRENCE: 3 Q. Under your contract with Jones 4 Day, I understand there's a cap on fees of 5 \$75,000. My question is: What fees have been 6 incurred to date? 7 A. \$75,000. 8 MR. LAWRENCE: That's it. Thank 9 you. 10 (Time noted: 3:53 p.m.) 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25</p>

<p style="text-align: right;">Page 178</p> <p>1 D. Babbel 2 A C K N O W L E D G M E N T 3 4 STATE OF) 5 : ss 6 COUNTY OF) 7 8 I, DAVID F. BABBEL hereby certify 9 that I have read the transcript of my 10 testimony taken under oath in my 11 deposition of March 7, 2014; that the 12 transcript is a true, complete and 13 correct record of my testimony, and that 14 the answers on the record as given by me 15 are true and correct. 16 17 _____ 18 DAVID F. BABBEL 19 20 Signed and subscribed to 21 before me this _____ 22 day of _____, 2014. 23 _____ 24 Notary Public 25</p>	<p style="text-align: right;">Page 180</p> <p>1 D. Babbel 2 I N D E X 3 Examinations Page 4 MR. LAWRENCE 5 5 6 E X H I B I T S 7 Babbel Page Line 8 Exhibit 1 Report of David F. Babbel.... 41 9 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25</p>
<p style="text-align: right;">Page 179</p> <p>1 D. Babbel 2 C E R T I F I C A T E 3 4 STATE OF NEW YORK) 5 : ss. 6 COUNTY OF NASSAU) 7 8 I, PATRICIA A. BIDONDE, a Notary 9 Public within and for the State of New 10 York, do hereby certify: 11 That DAVID F. BABBEL, the witness 12 whose deposition is hereinbefore set 13 forth, was duly sworn by me and that 14 such deposition is a true record of the 15 testimony given by the witness. 16 I further certify that I am not 17 related to any of the parties to this 18 action by blood or marriage, and that I 19 am in no way interested in the outcome 20 of this matter. 21 IN WITNESS WHEREOF, I have 22 hereunto set my hand this day, 23 March 17, 2014. 24 _____ 25 PATRICIA A. BIDONDE, RPR</p>	<p style="text-align: right;">Page 181</p> <p>1 D. Babbel 2 ERRATA SHEET FOR THE TRANSCRIPT OF: 3 Case Name: In Re: Lehman BROTHERS HOLDINGS. 4 Dep Date: March 7, 2014 5 Deponent: DAVID F. BABBEL 6 Pg. Ln. Now Reads Should Read Reason 7 _____ 8 _____ 9 _____ 10 _____ 11 _____ 12 _____ 13 _____ 14 _____ 15 _____ 16 _____ 17 _____ 18 _____ 19 20 21 _____ 22 Signature of Deponent 23 Signed and subscribed to before me 24 this ____ day of _____, 2014 25 _____ Notary Public</p>

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